THE CENTURY FOUNDATION
Issue Brief

# MEETING SOCIAL SECURITY'S LONG-RANGE SHORTFALL
## HOW WE CAN COPE—CALMLY—WITH A READILY MANAGEABLE CHALLENGE

BY ROBERT M. BALL

All is momentarily quiet on the Social Security front. So this may be an opportune time to take a calm look at the long-term financing shortfall facing the system.

As just about everyone surely understands by now, the aging of the baby boom generation will greatly swell the ranks of Social Security beneficiaries over the next thirty years, with the total, including children and disabled beneficiaries, increasing from about 48 million today to 89 million in 2035. The numbers will continue to grow after that, although more slowly, and are projected to reach 111 million around 2080, the end-point of the Social Security trustees' current seventy-five-year cost estimates.

How should we meet this sharply increasing cost?

Social Security has traditionally had two sources of income: the contributions of workers and their employers plus the investment income earned by the trust funds, which hold the accumulating excess of income over expenditures. Since 1983, when the most recent major amendments were enacted, the program has had a third source of income: taxation of the benefits of higher-income beneficiaries. In 1983, it was estimated that the income from these three sources would meet estimated costs over the following seventy-five years.

Because of changes since 1983 in some of the assumptions governing their long-range projections, Social Security's trustees now anticipate a deficit over the current seventy-five-year estimating period of about 2 percent of payroll. It is this long-term shortfall—which I believe should be seen as neither trivial nor overwhelming—that needs to be addressed. Moreover, we should not view the next seventy-five years as a closed period during which we build up the trust funds and then spend them down again. We need rather to keep building the funds throughout the seventy-five years so that future earnings on the funds will contribute to financing the system during the current seventy-five-year period and beyond.

We can do the job with three modifications of present law that are desirable in themselves in any event—and, very importantly, without further benefit cuts.

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## 1. Restore the Maximum Earnings Base to 90 Percent of Earnings

Our goal, as before, should be to build up and maintain an invested reserve that can help meet future costs—costs that, if covered on a strictly pay-as-you-go basis without the earnings from a reserve, would require a substantial increase in contribution rates (rising from today's 12.4 percent of payroll to an estimated 17.8 percent in 2080 and even higher beyond). Building the reserve, therefore, is very important. We should start by getting back to the practice of collecting the Social Security tax on 90 percent of earnings in Social Security employment, the traditional goal reaffirmed by Congress in 1983.

Present law contains a provision that was intended to keep the coverage level at 90 percent: an automatic annual increase in the maximum annual earnings base (now $94,200) by the same percentage as the increase in average wages. But this adjustment mechanism has not worked as planned because over the past twenty years the earnings of the higher paid have been rising much more than average wages—so an increasing proportion of earnings exceeds the maximum earnings base and thus escapes Social Security taxation. Today, only about 83 percent of earnings is being taxed. That seemingly small slippage translates into billions of dollars in lost revenues each year.

I propose to get us back to 90 percent, but to do so very gradually so that the additional tax on the 6 percent of earners with wages above the cap would increase very little year by year. I would increase the maximum earnings base by 2 percent per year above the increases occurring automatically as average wages rise. Thus, for example, the maximum this year would have gone up $1,884 (2 percent of $94,200) beyond the automatic increase, and the maximum tax increase beyond present law for an employee would have been $116.81 ($1,884 times the Social Security tax rate of 6.2 percent). In practice, this would mean that deductions from earnings for the highest-paid 6 percent of workers would simply continue for a few days longer into the year, and for their additional contributions they would receive somewhat higher benefits. For the 94 percent of covered workers with earnings below the cap there would be no change at all.

With this approach it is estimated that we would get back to the 90-percent level in thirty-six years. Such a gradual adjustment would be virtually painless—but this seemingly small change would reduce the projected 2 percent of payroll deficit to about 1.4 percent of payroll.

We could, of course, speed up the timetable in order to reach the 90-percent level sooner—in, say, ten years instead of thirty-six. That would reduce the deficit a bit more (just over 0.1 percent of payroll more to 1.3 percent of payroll) but because it would require adding 8 percent rather than 2 percent per year to the automatic adjustment we would substantially increase the burden of taxation on workers earning not much above the present maximum. For example, someone earning only $7,500 above the cap next year would pay an additional tax of $465. The slower timetable accomplishes nearly as much deficit reduction without such sharp increases in cost for anyone.

## 2. Earmark the Estate Tax for Social Security

In addition to restoring the taxable earnings base, I propose to establish a new source of funding by changing the estate tax into a dedicated Social Security tax beginning in 2010.

Present law gradually reduces the estate tax so that by 2009 only estates valued above $3.5 million ($7 million for a couple) will be taxed. President Bush then wants to abolish the estate tax permanently from 2010 on. Instead, I would freeze the tax at the 2009 level and earmark the proceeds for Social Security from 2010 on, thereby converting the residual estate tax into a dedicated Social Security tax just like the tax on employers' payrolls.

Such a tax would be an appropriate way to offset partially the deficit of contributions that was created in Social Security's early years—the so-called "legacy cost." At that time the sensible decision was made to pay higher benefits to workers nearing retirement age than would have been possible had their benefits depended entirely on the relatively small contributions that they and their employers would have had time to make.

Like most of the founders of Social Security, I once assumed that general revenues eventually would be used to make up for this initial deficit of contributions. The idea still makes sense, since there is no good reason why the cost of getting the system started should be met entirely by the contributions of workers and their employers in the future. Owners of capital should also pay a share as in the income tax. But there are no general revenues available because the president's policies have resulted in projections of deficits rather than surpluses as far as the eye can see. So it makes sense to substitute for general revenues this new dedicated Social Security tax based on the residual estate tax.

Indeed we may have to earmark the estate tax in order to save it. Repeal this year was prevented only because the Republican-dominated Senate fell three votes short of the 60 needed to prevent a filibuster and thus make passage of the proposal possible. Carving a modest tax on large estates out of general revenues to help pay off part of the cost of establishing a universal system of basic economic security would be a highly progressive and desirable way partially to offset the legacy cost. Moreover, to allow the transfer of huge estates from one generation to another without exacting a contribution to the common good is undemocratic in principle (as Tom Paine, among other early advocates of an inheritance tax, recognized). In almost all cases, the accumulation of huge estates cannot be attributed solely to the efforts of the estate owners; wealth also derives from the general productivity of the American economy and its infrastructure. Thus, a tax for the common good is a fair, partial payback for the common contribution to estate building.

An emotionally charged argument which has been leveled against the estate tax with considerable success has proven to be largely bogus. Those who inherit small farms and businesses are not being forced to sell them in order to pay the tax. A Congressional Budget Office study found that the $3.5 million exemption would almost totally protect against this risk.

Changing the estate tax to a Social Security tax reduces Social Security's projected long-term deficit by about 0.5 percent of payroll. When combined with restoration of the earnings base, it cuts the projected deficit slightly more than in half, to 0.9 percent of payroll.

These two changes bring the deficit slightly above close actuarial balance—that is, the point where income and costs are projected to be within 5 percent of each other over seventy-five years. The concept of close actuarial balance, which recognizes the impossibility of making exact forecasts so far into the future, has long been used by Social Security's trustees to help determine whether financing changes are needed. According to the trustees' middle-range assumptions, the cost of the present program today is estimated to average about 15.9 percent of payroll over the next seventy-five years, so a deficit of 0.9 percent of payroll would almost meet the close actuarial balance test (since 5 percent of 15.9 percent of payrolls is about 0.8 percent of payrolls).

Although I favor judging the adequacy of long-range financing according to the trustees' projections, it should be noted that the Congressional Budget Office anticipates a smaller long-term deficit than the trustees estimate. Thus these two changes alone might well be sufficient to eliminate the seventy-five-year deficit according to CBO's assumptions.

## 3. Invest in Equities

Even though the two changes described above bring the system near or within close actuarial balance, I believe we should further strengthen Social Security financing by diversifying trust fund investments. Some of the accumulated funds should be invested in equities, as is done by just about all other public and private pension plans. Several other government-administered programs such as those for the employees of the Federal Reserve and the Tennessee Valley Authority already make such direct investments in stocks, as does Canada's social insurance system. There is no good reason to require Social Security to invest only in low-yield government bonds.

Investment of a portion of Social Security's assets in stocks should be done gradually. I would propose starting with 1 percent in 2007, 2 percent in 2008, and so on, up to 20 percent in 2026 and capped at that percentage of assets thereafter. Investments should be limited to a very broad index fund (such as the Wilshire 5000) that reflects virtually the entire American economy. A Federal Reserve-type board with long and staggered terms should be created and assigned the limited but important functions of selecting the index fund, selecting the portfolio managers by bid from among experienced managers of index funds, and monitoring and reporting to the trustees and public on Social Security's investments.

Among other things, reliance on a board with long and staggered terms would guard against any risk that Social Security's investments could become subject to political manipulation as some opponents of this change ostensibly believe. 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 index fund.

(Of course, there would be no more reason to expect government interference under this plan than under President Bush's proposal, which would give government the responsibility for investing the individual accounts he advocates. So the argument against letting Social Security invest in stocks because of the alleged risk of market interference has lost some partisan traction lately. But the key point is that concerns about political interference can be addressed by limiting the amount of assets invested, requiring passive investment in a total-market index fund, and providing for oversight by a board structured to ensure its impartiality and autonomy.)

Investment by the trust funds has a major advantage over investment by individual accounts. Investing one's basic retirement funds in stocks is very risky for an individual because, among other reasons, he or she will ordinarily need the money upon retirement, and in order to be sure of making the income last until death will need to buy an annuity with the proceeds. But that could mean having to sell stocks and buy an annuity during a market downturn. As Gary Burtless of the Brookings Institution has demonstrated (by examining what would have happened if an individual-accounts system had been in effect in the past), timing is everything. A variation of just a few years—even months—in the time of buying an annuity can make a huge difference in its value. In contrast, investment by the trust funds is largely protected against comparable risk since Social Security would be able to ride out market fluctuations.

As with the investments of a private retirement plan, the goal of trust fund investing would be to build up and hold on to a reserve whose earnings would help meet future costs. This proposal is estimated to save about 0.5 percent of payroll. When combined with the other two changes outlined above, it brings the seventy-five-year deficit anticipated by the trustees to an estimated 0.5 percent of payroll, well below the test of close actuarial balance.

## Fail-Safe Funding

It bears emphasizing that all three of these proposals are desirable in themselves regardless of their importance in reducing the long-range deficit. And even if their adoption resulted in overfinancing the program, it would still be desirable to enact them and then provide for a reduction in Social Security tax rates when it became clear that the system was over financed.

Similarly, it would be a good idea to provide for a contingency contribution rate increase that would go into effect only if needed. A major objective in financing Social Security is to ensure that the build-up of the trust funds is maintained so that earnings on the funds continue to contribute to future financial stability during and beyond the current seventy-five-year estimating period. I therefore favor providing for a contingency contribution rate increase that may or may not be needed, depending on how closely experience follows the estimates. If despite the changes outlined above the trustees were to project that the trust funds would begin to decline within the next five years, the contingency rate increase would go into effect to prevent such a decline. If the need for this increase were to occur before the maximum earnings base had been restored to fully cover 90 percent of earnings, the timetable for restoration of the base would be accelerated, possibly obviating the need for the contribution rate increase.

It should be noted that there are other potential financing changes that could make a tax increase unnecessary. For example, adoption of the more accurate Consumer Price Index recently developed by the Bureau of Labor Statistics would result in slight reductions in Social Security's annual Cost of Living Adjustment, thereby saving an additional 0.5 percent of payroll and bringing the system into full actuarial balance according to the projections of the 2006 trustees report. And if Social Security coverage were to be extended, as it should be, to all newly hired state and local government employees, the seventy-five-year deficit anticipated under the middle-range estimates would become a surplus of over 0.2 percent of payroll.

It is also possible, of course, that because of productivity increases greater than previously assumed and other favorable factors, the trustees' middle-range estimates may prove to be too pessimistic and actual experience may be closer to their low-cost estimates. In that case just the three changes that I am proposing to make immediately effective—restoring the maximum wage base, earmarking the residual estate tax as a new dedicated Social Security tax, and diversifying the trust funds' investment portfolio—might well be sufficient to maintain the trust funds at the highest point achieved and produce a surplus beyond the next seventy-five years.

## Contrast with Administration Proposals

In contrast with relying on a fund build-up as these proposals do, the administration and its allies in Congress propose a strictly pay-as-you-go Social Security system, arguing that the trust fund bonds are worthless in meeting future costs since money has to be raised to redeem them if cashed in. Since costs will rise steeply, as previously explained, this view leads to the conclusion that Social Security's promised benefits cannot be paid for without huge tax increases, and that the only way to make the system sustainable is to cut benefits drastically, which they propose to do for all but the lowest earners. Over time this change would transform Social Security from a universal family protection system, useful to all, to a targeted welfare system for the poor—with everyone else expected to fend for themselves with their individual savings accounts. Under this scenario, public support for Social Security would rapidly evaporate.

The idea that the trust fund bonds are worthless and not the solid pledge of support for future beneficiaries they have previously been considered would be a repudiation of seventy years of government promises—and a major scandal if true. But it is not true.

The administration is correct, of course, in saying that the government has used the money it has borrowed from the Social Security trust funds for general purposes—just as it has used the money raised from the sale of all other bonds. And, of course, if bonds held by Social Security were called in, it would be necessary for the Treasury to borrow money or raise taxes to redeem them—just as would be the case in redeeming any other bonds issued by the government and held by private institutions and individuals. But this is quite beside the point. Workers covered by Social Security have made earmarked contributions ahead of time to pay toward their Social Security benefits. The Treasury has borrowed some of this money for general purposes and it owes to the Social Security fund what it has borrowed plus interest on the borrowings. The bonds held by the trust funds reflect this obligation.

The proposals outlined here will make it unnecessary to liquidate the trust funds, but some of the interest on the growing funds will be needed to pay benefits later on. The Treasury may have to stretch some to raise this money because the general fund has been operating at a deficit even without paying anything to Social Security. But paying this interest is a Treasury obligation to be met from general revenues and is not properly a Social Security problem at all.

Later on as the three proposals discussed here take hold, the Social Security trust funds will own an increasing proportion of the government debt, thereby reducing what the Treasury would otherwise owe to private institutions and the general public. Paying interest to Social

Security will be no more burdensome than paying the interest it would otherwise have to pay to other bond holders.

## A Balanced Approach

The three-point plan outlined here addresses Social Security's long-term shortfall solely by increasing income to the system. Why not cut benefits too? The answer is: because benefits are already being cut as changes in the retirement age are being implemented since these changes have the same effect as an across-the-board benefit cut. So a truly balanced solution to the long-term shortfall must call for more income, not more benefit cuts.

More fundamentally, we simply cannot afford to reduce the protection that Social Security currently provides. Social Security benefits are the major source of support for two out of every three beneficiaries and are vitally important to nearly all the rest. Benefit levels need to be maintained or better yet improved, particularly in light of the increasingly uncertain future faced by private pension plans—with traditional defined-benefit plans (many of them underfunded) now covering only about 20 percent of the private-sector workforce, and with the 401(k) individual savings plans that are to some extent replacing the traditional plans subject to the vagaries of individual investment experience and vulnerable to being cashed out before retirement.

It is in this context that we have to assess Social Security's long-term financing challenge. I believe that an accurate assessment can lead to only one conclusion: radical changes are unwarranted. And the changes I propose are anything but radical. As noted, the first three are desirable in themselves—and vastly preferable to the drastic benefit cuts proposed by the president or the major tax rate increases that would be required to cover current obligations in a pay-as-you-go-system.

Perhaps, in this moment of relative calm, we can make the case for common sense.

*Note:* The cost estimates in this article have been made by the Office of the Actuary, Social Security Administration, and are based on the middle-range estimates in the 2006 trustees report.

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