

Scare Tactics

Why Social Security Is Not in Crisis

Opponents of Social Security have been striving to convince American workers, especially young adults, that Social Security will no longer exist by the time they retire. Phrases such as “imminent crisis” and “unmanageable costs” lace this rhetoric. To a large extent, this alarmism is voiced by those who are hostile to government and therefore favor replacing all or part of one of this nation’s most successful and essential programs with private investment accounts.

The creation and expansion of Social Security in the twentieth century is one of the main reasons why the poverty rate among the elderly declined from more than 35 percent in the 1950s to around 10 percent today.¹ Social Security is essential to the economic well-being of millions of families, paying benefits to 89 percent of the U.S. population aged sixty-five or older. It is the major source of income (providing 50 percent or more) for two-thirds of its beneficiaries. It is the only source of income for 21 percent of them.² Without Social Security, 40 percent of those over the age of sixty-five would be in poverty.³

Diverting a portion of Social Security taxes into a system of private investment accounts—the favored option for those who claim the program is in crisis—would have profound consequences. It would undermine a guaranteed minimum retirement income, indexed to the rate of inflation, in exchange for a chance to win—or lose—in financial markets. It also would erode guaranteed support for dependents and survivors of retirees while greatly increasing the federal debt.

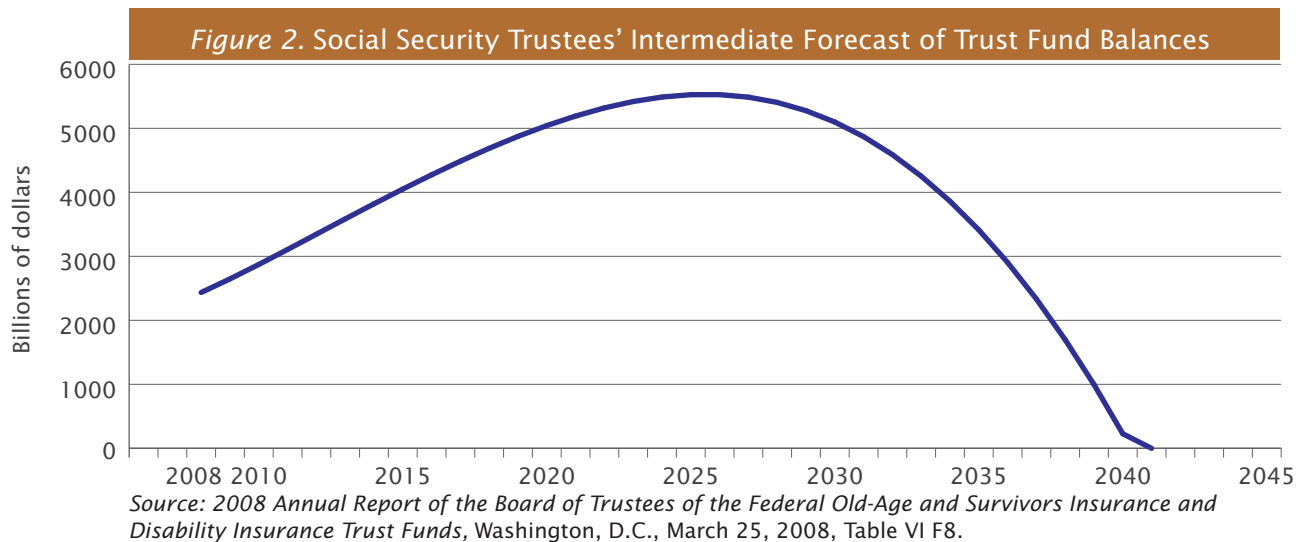
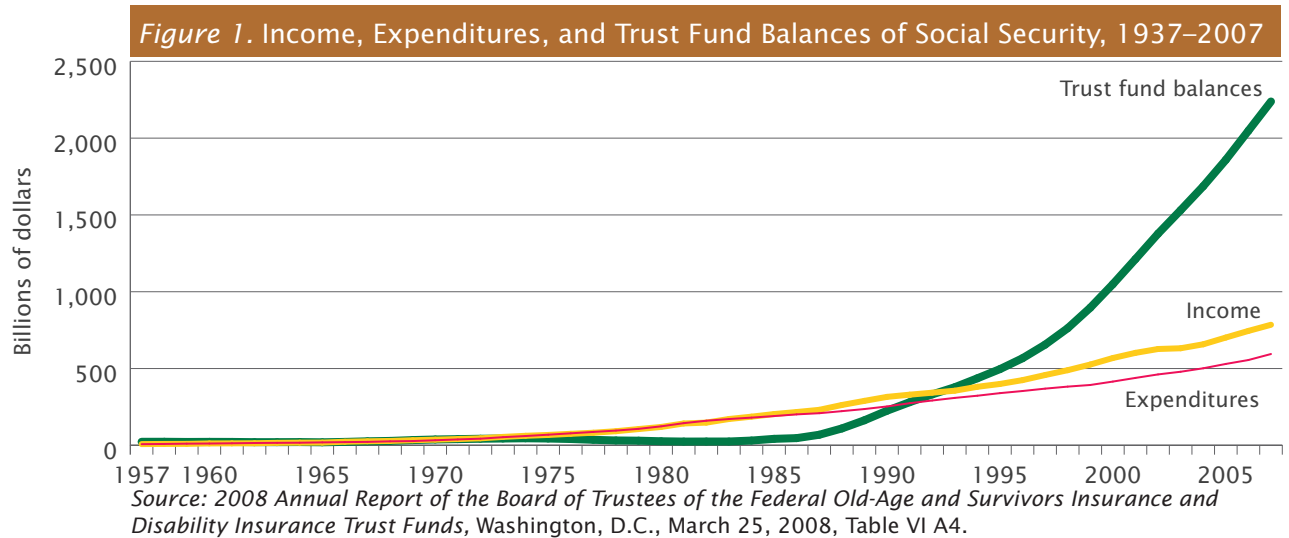
The argument for dramatically overhauling such a successful program largely depends on the claim that the system is in crisis and cannot survive without fundamental changes. The facts show, however, that Social Security faces no such crisis.

Better than Ever

Social Security is stronger today than it has been at any time in its history. The program had a major boost in 1983, when policies were implemented that had been recommended by a commission appointed by President Ronald Reagan and headed by Alan Greenspan. As a result, since 1983, the Social Security trust fund reserves have risen from essentially zero to more than \$2 trillion. These reserves were achieved primarily by a slight increase in the payroll tax and a gradual increase in the retirement age. Figure 1 shows how those changes caused reserves to balloon after the mid-1980s.⁴

As Figure 2 shows, trust fund reserves are projected by the Social Security trustees to grow for another twenty years. At that point, the trustees predict that the reserves will begin to decline, running out in 2041.⁵ (The Congressional Budget Office recently projected that the reserves would last until 2046.⁶) If nothing were done between now and the depletion of the reserves, benefits would have to be cut by about 25 percent thereafter.

Different people can have different definitions of a crisis, but it is hard to see how Social Security could be designated as in crisis today. After all, we have more than three decades to figure out how we want to fill the modest gap between payroll tax revenues and benefit payments that the experts predict will open in the future—though it would be least costly to fix the problem sooner rather than later. To get a sense of the magnitude of the adjustments necessary, consider this: if a third of the tax cuts of 2001 and 2003 had instead been used to strengthen Social Security, the financing challenge would be resolved.



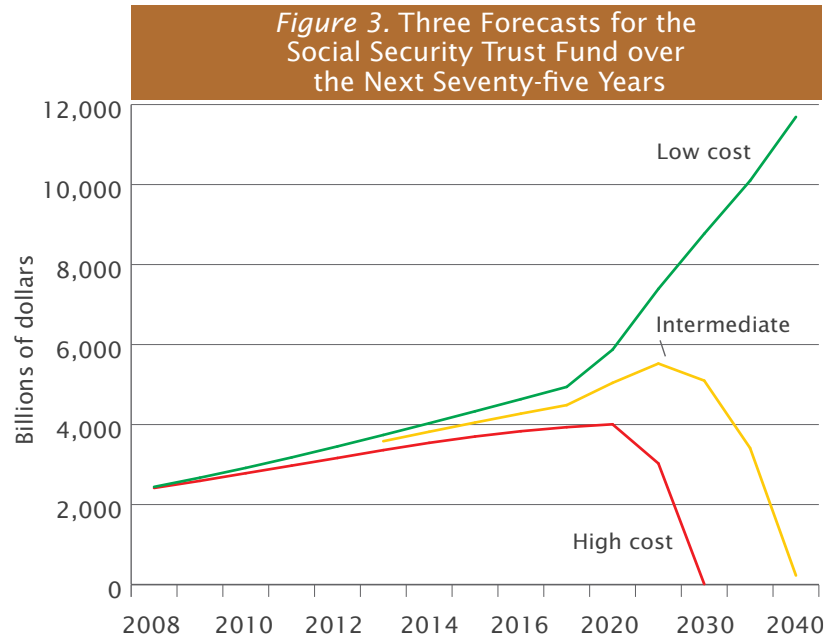
A Clouded Crystal Ball

How many children will your grandchildren have? What will they earn per year? These questions may seem far too speculative to answer at the moment, yet our long-run understanding of Social Security depends entirely on the answers to such questions. The further we look out into the future, the more clouded our crystal ball becomes. What is more, minor modifications in our assumptions produce radically different answers when projected fifty, seventy-five, or one hundred years into the future.

Recognizing this uncertainty, the Social Security trustees produce not only their “Intermediate” forecast, but a “Low Cost” and a “High Cost” forecast as well. Each of these has plausible assumptions but different consequences. As Figure 3 illustrates, the moderately optimistic Low Cost forecast shows reserves growing larger and larger, long after the Intermediate forecast has reserves depleted in 2041. Differences in these three forecasts are relatively small over the first decade, only becoming really significant after 2020.

As it happens, very small modifications in assumptions can generate big differences in forecasts. Take, for example, productivity growth.⁷ Actual productivity growth—a critical element in forecasting the future of Social Security—varied significantly between 1996 and 2006, ranging from 1.0 percent to 3.0 percent per year and averaging 2.1 percent per year. Over a longer period, from 1966 to 2006, productivity growth averaged 1.7 percent per year. The Intermediate forecast assumes that productivity will grow at 1.7 percent per year in the long run, well below the rate of recent years. The Low Cost assumption is that productivity growth will remain at 2.0 percent per year, above its 1966–2006 average but slightly below more recent levels.

Another unknown that can greatly change the outlook for Social Security is future immigration, because most immigrants are young people paying taxes into the system, raising the ratio of workers to retirees. The Intermediate forecast assumes that net legal and illegal immigration will be significantly lower in the future than in the recent past. In that sense, the forecast is quite conservative because, as the population of the world and the United States grows, it is entirely conceivable that the number of immigrants to the United States will grow as well.



Source: 2008 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Washington, D.C., March 25, 2008, Table VI F8.

Table 1. History and Assumptions behind the Long Run Intermediate and Low Cost Social Security Forecasts—Productivity Growth

	Recent History	Longer History	Assumption: Intermediate	Assumption: Low Cost
Productivity Growth	2.10%	1.7%	1.7%	2.0%

Source: The 2008 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Washington, D.C., March 25, 2008, Table V B1.

Recently, Northwestern University economist Robert J. Gordon, a widely respected scholar, has argued that productivity growth will be much faster in the future than the Social Security trustees assume. Describing the trustees' estimate of future output growth as "pathetic," Gordon concludes that productivity growth will exceed by far the trustees' Low Cost estimates, projecting an average rate of increase of about 2.5 percent annually.⁸ Likewise, Gordon and others have argued that immigration levels will exceed even the low-cost estimate, further easing the pressure on Social Security.

Worthless IOUs?

In July 2001, Treasury Secretary Paul O'Neill said, "The Social Security Trust Fund does not consist of real economic assets." The treasury secretary was the most prominent among those spreading the idea that the assets in the trust funds are worthless paper. Are these balances, which the trustees predict will reach \$5.5 trillion in the mid 2020s, really just an accounting fiction?

Before answering that question directly, let us note that all financial claims are "nothing but paper." A deed to a house, a corporate bond, a pension promised by United Airlines, a share in Bear Sterns, and even a dollar bill are pieces of paper with words on them. Whether those rights and promises are worth anything depends on the rule of law and the institutions backing up paper promises.

The trust funds consist by law of United States Treasury securities. These are promises by the government to pay the holder interest and principal in the future. The prices people are willing to pay to acquire these promises indicate their faith in the institution that issues the promise. By comparing the prices of various financial assets, we can see how much of a "risk premium" is needed to induce people to buy any given financial asset. No private company, no institution in the world has a lower risk premium than the U.S. government. Wealthy institutions and people of the world are expressing their faith in the promises of the U.S. government by buying U.S. Treasury bonds, even though the prices are higher than for other assets. If the government of the United States defaults on its Treasury bonds, the Social Security trust funds will indeed turn out to be worthless paper. It could happen. The government of the United States could go the way of Enron, Pan Am, or Bethlehem Steel. But the smart money of the world in financial markets is betting against that.

The trust fund balances can be counted on to provide resources in the future. More important, they represent real saving in the economy that will help increase future production to provide income for retirees and workers. Since the federal government can sell some of its bonds to the trust funds, it does not need to finance as much of its deficits by borrowing from the private sector. This leaves more saving to finance private investment. Like any other institution, business, or household, the Social Security system adds to national saving when it takes in more income than it spends. As long as the Social Security surplus does not lead to tax cuts elsewhere, or to increases in spending, the surpluses accumulated in the trust funds make more resources available to finance investment and economic growth. In turn, that growth strengthens the capacity of the nation to adjust to the retirement of the baby boom generation.

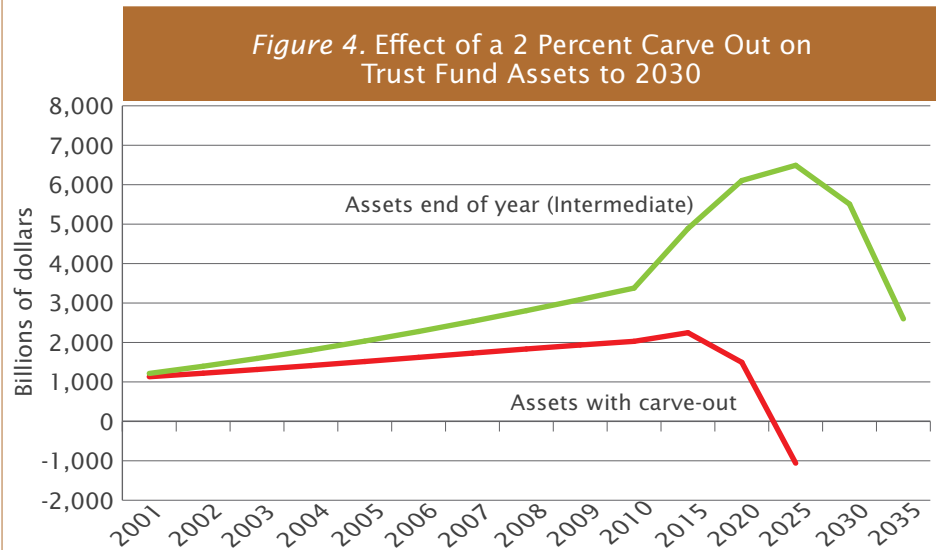
Privatization: The Road to a Real Crisis

Some advocates of privatization want to divert revenues out of Social Security into private investment accounts. Under these proposals, in the future each individual's retirement income would depend on how the investments in the accounts performed. The fundamental problem with this idea is that the Intermediate forecast of the trustees and the forecast of the Congressional Budget Office predict that there will not be enough resources available to afford benefits to current retirees and at the same time establish private accounts for future retirees. The same dollar cannot be put into an individual account and also be used to pay for current benefits. If we want private accounts, the taxes to pay for them must come on top of the payroll taxes already slated to pay for Social Security. If the resources committed to Social Security are reduced, that would greatly aggravate the financial shortfall forecast for the program.

Figure 4 illustrates what would happen to the long-run balances in the trust funds with and without diverting a portion of payroll tax revenues into private accounts (2 percent of payroll is one common proposal).

Figure 4 shows that if 2 percent of payroll were carved out of Social Security and diverted to individual accounts, the trust funds would peak at little more than \$2 trillion and would be exhausted in twenty years—instead of peaking at more than \$6 trillion in twenty years. Diversion of payroll taxes into private accounts would move the clock ahead twenty-five years toward the problems forecast for Social Security. Ironically, today's young people, many of whom think that private accounts would benefit them, would face a retirement security crisis that much sooner.

What is more, it would be almost impossible for a system of flexible private accounts to achieve the very low operating costs of Social Security. Experience in other countries as well as management fees of mutual funds in the United States suggests that universal private pension accounts would cost many times the 1 percent of contributions that Social Security costs us today.



Source: Peter A. Diamond and Peter R. Orszag, "An Assessment of the Proposals of the President's Commission to Strengthen Social Security," The Brookings Institution, Washington D.C., June 2002.

Longtime Social Security Commissioner Robert M. Ball developed a comprehensive plan to resolve the program's projected financial shortfall through a simple combination of revenue increases and cost reductions.¹⁰ Avoiding unpopular fixes such as raising the retirement age or taxing all income, Ball's plan would:

- ◆ Gradually raise the cap on earnings covered by Social Security so that once again 90 percent of all income would be taxed and counted for benefits. This was the threshold set by Congress in 1983, the last time it considered this issue. Social Security taxes are now being applied to only 83 percent of earnings. By very slowly phasing in the change, the impact on the 6 percent of affected workers would be very modest.
- ◆ Dedicate future proceeds of a revised estate tax to Social Security beginning in 2010. 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 tax would be frozen at that level, with the revenues directed toward Social Security.
- ◆ 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. Other government retirement systems, such as ones for employees of the Federal Reserve Board, the Federal Railroad Retirement Board, and the Tennessee Valley Authority, also invest directly in stocks.

Conclusion

Social Security is not in crisis. Even pessimists predict that the program will be able to meet every promise for decades. And even mildly optimistic assumptions generate forecasts of no crisis at all in Social Security, ever. There is no reason to rush to dismantle this basic part of our social safety net, a system that is vital to a large majority of our elderly population. We must continue to keep a close eye on Social Security, but the system is not broken.

Notes

1. *Income, Poverty, and Health Insurance Coverage in the United States: 2005*, U.S. Census Bureau, Washington, D.C., August 2006, p. 15, available online at <http://census.gov/prod/2006pubs/p60-231.pdf>.
2. *Annual Statistical Supplement to the Social Security Bulletin*, Social Security Administration, Washington, D.C., August 2006, p. 11, available online at <http://www.ssa.gov/policy/docs/statcomps/supplement/2006/supplement06.pdf>.
3. "Privatization by the Numbers," Center for American Progress, May 2005, available online at <http://www.americanprogress.org/issues/2005/05/b306535.html/print.html>.
4. From the start, Social Security was a "pay-as-you-go" system: income from taxes roughly matched total benefits paid out. Relatively small trust fund reserves were created in order to remove Social Security from the annual congressional budget process. After the 1983 changes, the trust funds have been greatly increased in order to accumulate reserves to pay out benefits for future retirees as the huge cohort of "baby boomers" reaches retirement age.
5. John L. Plamer and Thomas R. Saving, "A Summary of the 2007 Annual Reports," Social Security and Medicare Boards of Trustees, April 23, 2007, available online at <http://www.ssa.gov/OACT/TRSUM/trsummary.html>.
6. "Updated Long-Term Projections for Social Security," Congressional Budget Office, June 2006, available online at <http://www.cbo.gov/ftpdocs/72xx/doc7289/06-14-LongTermProjections.pdf>.
7. Future output available to provide income to workers and retirees depends on the number of future workers and on future output per worker, that is, on productivity.
8. Robert J. Gordon, "Exploding Productivity Growth: Context, Causes, and Implications," *Brookings Papers on Economic Activity* 2:2003 (Washington, D.C.: Brookings Institution Press, 2004), pp. 207–98.
9. *Ibid.*, p. 264–68.
10. Robert M. Ball "Meeting Social Security's Long-Range Shortfall: How We Can Cope—Calmly—with a Readily Manageable Challenge," The Century Foundation, September 5, 2006, available online at <http://www.tcf.org/list.asp?type=PB&pubid=531>.

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