Shadow over Social Security

A Survey of Recent Articles

Social Security may well be the most popular government program ever established in the United States, and no American politician wants to monkey with it. But the next president, together with Congress, will be under great pressure to make some major changes in the venerable New Deal creation. Economists and others have been debating how radical the changes should be.

"Thanks to our aging population, longer lifespans, generous benefit hikes, and stagnant growth," declares Matthew Miller, economics editor for the *New Republic* (Apr. 15, 1996), "the one thing certain about Social Security is that before the baby boom retires something will give. Call it Ponzi's revenge." The number of workers paying into the system per retiree was seven in 1950 and five in 1990. It will be fewer than three in 2030, by which time all the baby boomers will have turned 65.

"Financially," Miller says, "these trends mean the 'pay-as-you-go' nature of Social Security, in which today's workers are taxed to fund the retirement of their parents, simply can't continue without big tax hikes or benefits cuts for tomorrow's workers."

Under existing law, notes Martin Feldstein, an economist at Harvard University and former chairman of the President's Council of Economic Advisers, writing in the *American Economic Review* (May 1996), government actuaries predict that the payroll tax rate will need to increase over the next 50 years from about 12 percent to more than 18 percent, and perhaps as high as 23 percent.

"The prospect of ever-increasing taxes is unacceptable to most Americans," Barry Bosworth, a Senior Fellow at the Brookings Institution, points out in the *Brookings Review* (Fall 1995). "And the prospect of ever-diminishing benefits is no better."

Feldstein adds that the Social Security system is also partly responsible for the disastrously low rate of private saving in the United States. People expecting generous benefits in the future save less of their own money than they ought to—nearly 60 percent less, he estimates. That represents a significant loss of investment capital to the nation's economy.

When Social Security was last "fixed" in 1983, it was thought that the payroll tax increases and other changes would keep the system in actuarial balance for more than 75 years, Bosworth notes. But demographic factors, including immigration and lower birth rates, as well as the fact that Americans are living longer and retiring earlier, have confounded that expectation. Although Social Security is currently running a surplus—$69 billion in 1995—its trustees said in a 1995 report that the Social Security trust fund would run dry in 2030. (The assets accumulating in the trust fund today are less than five percent of Social Security liabilities. More than 90 percent of payroll tax receipts are still paid out immediately as benefits.)

Rescue plans seem to be proliferating, which may be a sign that momentum is building for major changes. In the *Atlantic Monthly* (May 1996), Peter G. Peterson, a New York investment banker and former U.S. secretary of commerce (1972–73), proposes an annual "affluence test" that would progressively reduce Social Security (and other entitlement) benefits to those with household incomes above $40,000. He would also raise the retirement age at a faster rate. (Congress already has raised it from 65 to 67, to be phased in from 2000 to 2027.) Finally, Peterson calls for a mandatory, fully funded, privately managed, and portable system of personal retirement accounts. "The system I envision would initially supplement Social Security—and over time might increasingly substitute for it," he says.

The federal Social Security Advisory Council, headed by Edward M. Gramlich, an economist at the University of Michigan, worked for two years to come up with recommendations for overhauling the system. The 13 members of the panel have not been able to agree on a single approach but instead have put forward three different ones, summarized by Gramlich in the *Journal of Economic Perspectives* (Summer 1996):

Maintain the current system. This approach would tax as regular income all Social Security benefits that exceed an individual's previous employee contributions. That, Gramlich notes, might be "the most sensible way" to get current retirees, "who already get a good money's worth return on their Social Security contributions," to help solve the system's problems. This approach would also have the Social Security trust fund gradually invest up to 40 percent of its assets in the stock market—instead of, as is now done, in Treasury bills—to take advantage of the historically higher returns. One danger: with more than $1 trillion—one-seventh of the gross domestic product (GDP)—involved, management of the money might become politicized.

Individual accounts. "My personal favorite," Gramlich writes, "tries to scale back benefits to eliminate today's long-term actuarial deficit." The normal retirement age would gradually rise, and benefits for high-wage workers would be cut. Then comes the critical part: mandatory individual savings accounts funded by a 1.6 percent payroll tax. The accounts would be held by the Social Security system, but individuals would be free to choose whether to invest their funds in bond index funds, stock index funds, or some combination. This would reduce, if not eliminate, the danger of politicized investment decisions.

Personal security accounts. Instead of small-scale individual accounts, this scheme would create much larger individualized savings accounts, called "Personal Security Accounts." Of the 12.4 percent payroll tax (paid half by employers, half by employees), five percent would be diverted to those accounts, which could be administered by private registered investment companies. Government benefits would be reduced correspondingly. Feldstein favors a complete switch to a fully funded, privatized system of individual accounts.

The biggest problem with privatization, notes Matthew Miller, is figuring out "how to get from here to there. The trick in switching midstream from 'pay-as-you-go' to a pre-funded private retirement system is that one generation has to pay twice: first for the retirement of its parents and then for its own. . . . Chile, whose successful privatization of Social Security these reformers love to tout, paid for the change thanks in part to the five percent of GDP budget *surplus* they were running when they switched. No such luck here."

Radical privatization may be unlikely, but there is little doubt that the New Deal program is due for a major overhaul. "Whether there's a Republican or Democrat in the White House, they'll be forced to make changes in Social Security," Senator Bob Kerrey (D.-Neb.) told the *Wall Street Journal* (July 9, 1996). "The world has changed a lot since 1935."

Cutting the Price of Power

"Electrical Storm" by Tom Arrandale, in *Governing* (July 1996), 2300 N St. N.W., Ste. 760, Washington, D.C. 20037; "Electric Utilities: The Argument for Radical Deregulation" by Peter Navarro, in *Harvard Business Review* (Jan.–Feb. 1996), and Thomas R. Kuhn et al., "Electric Utility Deregulation Sparks Controversy," in *Harvard Business Review* (May–June 1996), Boston, Mass. 02163.

Deregulation has come to telecommunications, airlines, and other industries, and now it seems to be the electric utility industry's turn. Traditionally, electric power has been supplied by tightly regulated local utilities that enjoy government-sanctioned monopolies. Some 200 such utilities today provide three-fourths of all the electric power in the United States. "But that monopoly system is about to break up," reports Arrandale, a freelance writer.

In high-rate states such as California (where the price of electricity is roughly 50 percent above the national average), major industries have been seeking to cut their electric bills, and even threatening to move out of state. In 1992, Arrandale notes, Congress "cleared the way for unregulated private companies with efficient gas-fired generating plants to sell power to wholesale customers [i.e. utilities themselves] at cheaper prices. This year, the Federal Energy Regulatory Commission ruled that these discount competitors must be allowed to use the long-distance transmission grids that the utilities have built to carry power across the countryside." Now, the unregulated companies want states to give them "access . . . to the poles and wires along the streets and highways of virtually every community in the country." Massachusetts has already embraced the concept, and small-scale experiments are under way in Michigan and Maine. Meanwhile, mergers have sharply increased, as companies seek to cut costs and gain control over large regional markets.

In the debate over how far and how fast