The Periodical Observer

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Social Security and Beyond

A Survey of Recent Articles

In his State of the Union speech in February, President George W. Bush (1) warned that if nothing is done, Social Security will be "bankrupt" by 2042, and (2) urged that some Social Security funds be diverted into voluntary personal retirement accounts. Bush's sketchy proposal has been severely criticized, but it has also touched off a wide-ranging debate about everything from income inequality to the nature of retirement itself in the 21st century.

Although Bush's two ideas became virtually inseparable in much of the subsequent public discussion, many critics were quick to point out that personal retirement accounts would not prevent insolvency. In fact, they would make the crisis (if there really is one) worse, at least in the short term.

"Currently, Social Security is running a hefty surplus; the payroll tax brings in more dollars than what goes out in benefits," notes Roger Lowenstein, a contributing writer to *The New York Times Magazine* (Jan. 16, 2005). "By law, Social Security invests that surplus in Treasury securities, which it deposits into a reserve known as a trust fund, which now holds more than one and a half trillion dollars. But by 2018, as baby boomers retire en masse, the system will go into deficit. At that point, in order to pay benefits, it will begin to draw on the assets in the trust fund." The Social Security Administration has since slightly revised its estimates: The deficit will arrive in 2017, and the trust fund will be exhausted by 2041. "At that point, as payroll taxes continue to roll in, [the system] would be able to pay just over 70 percent of scheduled benefits."

That isn't necessarily "bankruptcy," but it *is* a shortfall—which could be avoided by some combination of payroll-tax increases and cuts in benefits. The payroll tax is currently 12.4 percent, levied on the first $90,000 of annual wages. Half is paid directly by the employee, half by the employer. As do many others, Bush opposes the 1.5 percentage point increase in the payroll-tax rate that would eliminate the specter of 2041, but he hasn't ruled out a different way of meeting the challenge: raising the $90,000 annual cap.

Trimming benefits would also avert insolvency. Currently, Social Security benefits are adjusted every year to keep pace with inflation. But the *initial* benefit levels of new retirees are set according to a formula that takes into account their past earnings and an index of wage growth. If initial benefits were indexed instead to changes in the cost of living—as they were before 1977—that alone would assure the system's solvency, notes Irwin M. Stelzer, director of economic policy studies at the Hudson Institute, in an article in *The Weekly Standard* (Jan. 17, 2005). Reasonable arguments can be made for either of those "escalators," Stelzer adds. "Escalate with wages, and you retain the standard of living of retirees*relative* to those of active workers. Escalate with inflation, and you retain the *absolute* standard of living of retirees." But a switch to the inflation index would amount to a reduction of promised benefits, since wage growth outpaces inflation over time.

In *The Wall Street Journal* (March 15, 2005), financial executive Robert C. Pozen, a Democratic member of a federal panel on Social Security reform during Bush's first term, proposes a hybrid solution that would buttress the system's redistributive character: Index the benefits of the poor to wages and those of the affluent to inflation, with the benefits of those in the middle (i.e., with incomes of $25,000 to $113,000) linked to a mix of the two indexes. By allowing workers to establish modest private accounts under the Social Security umbrella, Pozen's plan would probably avert any loss of benefits. The federal government would still need to borrow to cover the transition costs, but much less than under other plans.

Another way of cutting benefits would be to raise the retirement age. In 1983, Congress hiked it from 65 to 67, a change that is very slowly being phased in. A further increase would be justified, argues William Saletan, chief political correspondent for *Slate* (Feb. 22, 2005). In 1935, the committee that designed Social Security noted that "men who reach 65 still have on the average 11 or 12 years of life before them; women, 15 years." Today, life expectancy at 65 is about five years longer than that, so providing benefits for the same span of retirement would mean raising the retirement age to between 70 and 75.

In proposing private accounts financed by funds diverted from payroll taxes, the president has encountered resistance, in part because Washington would need to borrow vast sums to replace the diverted funds. And some economists say the assumptions about returns from stocks and bonds are too optimistic. Yet there is widespread support for encouraging Americans to save more for retirement. The puzzle is how to achieve that goal. C. Eugene Steuerle, a senior fellow at the Urban Institute, and two colleagues report in *Tax Notes* (Dec. 20, 2004) that the government now forgoes more revenue for the sake of retirement tax breaks ($112 billion in 2004) than Americans save for all purposes (an estimated $101 billion).

Half of all American households whose heads are nearing retirement age have only $10,000 or less in a 401(k) plan or individual retirement account, according to a study by William G. Gale, J. Mark Iwry, and Peter R. Orszag, all affiliated with the Brookings Institution (www.brookings.edu/views/papers/20050228_401k.htm). Only about 75 percent of eligible workers participate in a 401(k) plan, and only five percent of plan participants contribute the maximum allowable amount.

Paul O'Neill, Bush's first Treasury secretary, has advanced a novel longer-term proposal: Have the federal government deposit $2,000 annually in accounts for Americans aged one to 18. With no additional contributions, and assuming a relatively conservative six percent average annual rate of return, "those savings would grow to $1,013,326 at age 65," he writes in *The Los Angeles Times* (Feb. 15, 2005). Problem solved.

What's seldom mentioned in the current debate, however, is that there may not be a problem at all. The Social Security Administration makes three different 75-year projections of the system's health based on different economic and demographic scenarios, and today's debate revolves around the "intermediate" forecast. "If its more optimistic projection turns out to be correct," observes Lowenstein in his *New York Times Magazine* article, "then there will be no need for any benefit cuts or payroll-tax increases over the full 75 years." Over a recent 10-year span, the "optimistic" estimates actually proved very accurate. Stelzer, in his *Weekly Standard* piece, says "a case can be made" for doing nothing. "But we should never discourage politicians bent on prudence." His suggestion: Scrap the Social Security payroll tax, which is regressive and also discourages employers from hiring new workers, and replace it with another source of revenue.

David M. Walker, the U.S. Comptroller General, argues in a useful overview of the issues (http://www.gao.gov/new.items/d05397t.pdf) that Social Security must be considered in a larger context: "Compared to addressing our long-term health care financing problem, reforming Social Security ought to be easy lifting."