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FIXING SOCIAL SECURITY
The Clinton Plan and Its Alternatives

by Edith Rasell and Jeff Faux

After a lifetime of participating in the workforce, workers should be able to count on a secure retirement. Social Security is the most effective way working people have of guaranteeing themselves a reliable income in their old age. Two-thirds of retired workers receive 50% or more of their income from the program.

Given the importance of Social Security, it is easy to understand why people are concerned for its stability. The Social Security Trust Fund, which receives the payroll taxes that are paid out as benefits, is solvent. In fact, it is better than solvent — it actually brings in more than enough money to pay current benefits. But to ensure future solvency, each year the Social Security Trustees are required by law to assess the program's finances for the next 75 years. Their recently released 1999 report provides additional evidence that, despite the oft-heard alarmist rhetoric, there is no crisis in the Social Security program. The trustees project that the program, as it currently exists, will be able to pay full benefits until 2034, which is two years longer than their 1998 estimate. The fund is now projected to have revenues sufficient to pay 73% of benefits in 2035 and about 67% of benefits in 2075 (if nothing were to change between now and then).

In the latest report, the trustees conclude that "the long-term financing problem facing Social Security is significant but could be solved by *small gradual changes* if those changes are enacted soon" (Social Security and Medicare Board of Trustees 1999, emphasis added).

The president has proposed a plan to ensure that the Trust Fund can pay Social Security benefits through 2055,[1] primarily by using government surpluses to increase the program's assets. Congressional Republicans tend to favor a more radical strategy of privatization that would transform Social Security into individual private investment accounts.

In this briefing paper we explain the Social Security problem and its simplest, most sensible solution, a solution that requires only small, gradual modifications to the system that are being overlooked by both the president's plan and the Republican privatization alternatives. As shall be seen in this paper, not all

proposals are created equal. The president's plan, while flawed, could save the Social Security program for future retirees; the privatization proposals are almost sure to destroy it.

Defining the questions

What are some of the issues that must be addressed when attempting to assess Trust Fund solvency for an entire 75-year period? One is the inherently difficult nature of 75-year projections. As mentioned before, the 1999 trustees' report showed that the Social Security Trust Fund will be able to pay full benefits for the next 35 years, until 2034. Last year's report projected that full benefits could be paid through 2032, and the projection in 1997 was 2029. The variability of these estimates illustrates the uncertain nature of 75-year projections.

So exactly how is the Trust Fund projected to fall short? Two-thirds of the Trust Fund deficit is attributable to the trustees' safe assumption that people will be living longer in the future. One-third of the deficit is based on the assumption that economic growth will slow down due to population and productivity growth lower than that of the past 75 years. These particular trends, however, can't be forecast with much certainty. Even ignoring the strong economic growth of the past few years, the Social Security trustees' projections seem unduly pessimistic.

As we all know, foretelling the future is a tricky business. Given the difficulty of accurately projecting trends over the next 75 years, it would be best to avoid radical changes in the Social Security program, especially when those changes have the potential to inflict financial harm on the least affluent. At the same time, it would only be prudent to prepare for a possible future deficit in the Social Security Trust Fund.

The common sense economics of doing so are relatively straightforward. There are really just two options: bring more money into the program or cut benefits, the latter of which could be accomplished by either reducing retirement checks or increasing the age of retirement.

Cutting benefits to save Social Security would be contradictory to the program's purpose. The provision of benefits *is* the purpose of the program. Saving Social Security means maintaining the benefits that are the basic social safety net for American workers.

It would also be unfair. Most seniors already have quite low incomes — half are below $18,000, *even after including their Social Security benefits.* Reducing their benefits further would be a breach of the social contract. The current generation of retirees already paid for the full benefits of the previous generation of retirees. The workers that will be retiring over the next few decades have been paying more into Social Security (both to pay for current retirees and to pre-fund their own benefits) than previous generations of workers, and most will now have to wait longer (until they are 66 or 67 years old) before they can receive benefits. The promise to these workers of a secure retirement must be kept.

In addition, the generation of people working in 2014 and beyond, even according to the pessimistic forecasts of the Social Security trustees, will be more affluent on average than this one. Cutting current benefits would mean transferring benefits from a poorer generation to a wealthier one.

There are, of course, high-income retirees whose Social Security benefits could be cut with little hardship. But they are already taxed on some or most of their Social Security income. At any rate, cutting this group's benefits still would not generate enough savings to make a major contribution to solving the problem.

Thus, truly saving Social Security requires increasing the Trust Fund's revenue.

Why the problem seems complicated

Getting additional revenue into the Social Security Trust Fund seems complicated because of the way the system is now financed. Until 1982, the system was funded on a pay-as-you-go basis. Social Security taxes paid by current workers provided for the benefits of those who were then retired, with each generation paying for the retirement of the one before it.

In 1982, on the recommendation of a commission headed by current Federal Reserve Board chairman Alan Greenspan, Congress partially abandoned the pay-as-you-go system. It raised Social Security taxes and delayed the age of retirement (to take effect starting in 2000), creating a rising surplus in the Trust Fund to be used to offset the cost of retirements in the 21st century.

To earn interest on the surplus funds, the Trust Fund must convert the excess tax revenue into interest-earning assets that it can later redeem when payments to retirees begin to exceed annual tax revenue (which should happen in 2014 according to projections). To this end, the Social Security Trust Fund buys the safest investment in the world — U.S. Treasury bonds. In 2014, the fund will need to begin converting these bonds back to *cash,* and the U.S. Treasury will have to come up with the money to redeem those bonds.

The amount of money that will be needed to pay back the Trust Fund is large but not overwhelming. In 2033, the largest amount of bonds will need to be redeemed — equal to about 1.8% of gross domestic product (GDP). There have been greater events in U.S. history (e.g., war, population surges, etc.) that the economy has handled without causing undue financial stress to the country. Moreover, the trustees project that, even with the forecasted slowdown in economic growth, when these bills come due, the nation will be much richer than it is today and therefore more able to raise the funds needed. Under the trustees' pessimistic projections, GDP is expected to grow from the current level of $8.4 trillion in 1998 to $11.1 trillion in 2015 (an increase of 32% after adjusting for inflation). By 2035 GDP is expected to grow 28% more to $14.2 trillion. Individuals will be wealthier as well; real wages will rise 17% by 2015 and 40% by 2035. And given that these are pessimistic predictions, there is a good chance that in the fourth decade of the 21st century Americans will be even richer than the forecasts suggest. Nevertheless, additional funds will be required, so we should thoughtfully prepare for this future claim on the nation's resources.

To preserve the integrity of this vital program, two fundamental issues must be resolved:

1. How to ensure that the Trust Fund has enough assets to cover the shortfall after 2032.
2. How to prepare for raising the cash that will be needed beginning in 2014 when the fund will start to redeem its U.S. Treasury bonds.

The common sense answer

Since two-thirds of the funding shortfall is due to people living longer, and therefore spending more years in retirement, it is appropriate to increase the contributions to the system to accommodate these longer life spans. This should be done in two steps. The first would do away with the current "cap" or upper limit on earnings subject to Social Security taxes, which now stands at $72,600, and raise benefits accordingly for those paying higher taxes. By taxing all earnings (and by incorporating into the Trust Fund projections some recent technical changes in the consumer price index), fully 75% of the funding shortfall would be eliminated. Second, the remaining balance of the shortfall could be eliminated by raising

the tax rate from 12.4% (which is split evenly between workers and employers) to 13.0%. For an average-wage worker earning $30,000 per year, this would mean an additional $85 per year in taxes, with a comparable increase for employers. This is a small price to guarantee all workers a secure retirement income.

As part of this revision in the payroll tax, we could also make changes to ease the tax burden on low- and moderate-income workers. In 75% of working families (primarily those with low and middle incomes), payroll tax liabilities exceed those of the federal personal income tax. To reduce the tax on these workers, we could exclude the first $5,000 to $10,000 in earnings from the employee share of the tax. The revenue lost through this exclusion could be offset by revenue from the federal budget surplus.

The additional revenues resulting from raising the cap on income subject to the payroll tax, plus the payroll tax increase, would be transferred to the U.S. Treasury in exchange for treasury bonds. Inasmuch as the government will soon be running its own surplus, it should use the additional Social Security proceeds to pay down its own outstanding bonds — the publicly held national debt. This will reduce expenditures for interest on the debt and, when the time comes for the Social Security Trust Fund to redeem the bonds for cash, the government will have a greater capacity to borrow all or a part of the money it will need from the private market.

Eliminating Social Security's 75-year shortfall by extending the tax base would also have other advantages, such as freeing up the expected surpluses in the federal budget to finance programs like Medicare and provide insurance coverage to the nonelderly uninsured. It would also provide funding for critically needed and long postponed public investments in education, training, infrastructure, and technological development. These kinds of investments would increase economic growth and future incomes, making it even easier for future generations to pay the costs of Social Security and Medicare.

The president's plan

Unfortunately, fear of raising taxes — even by a small amount — currently pervades the political debate in Washington. This leaves the most common sense solution to the Social Security problem with little support in Congress or the White House. Instead, President Clinton has proposed a "second-best" plan for Social Security that obtains the needed additional funds from two sources: the expected federal budget surpluses and investments of Social Security trust funds in the stock market.[2]

Using the surplus

The president proposes strengthening Social Security's finances by transferring to the Trust Fund over the next 15 years an additional $2.7 trillion dollars, or nearly two-thirds of the expected budget surplus. The Social Security program will use these funds to purchase treasury bonds. Funds received by the treasury from the sale of these bonds to the Trust Fund will be used to pay off the federal debt held by the public. These additional funds received by Social Security will extend the Trust Fund's solvency by 17 years — from 2032 to 2049 (see endnote 1). The scheduled payment to Social Security would be made even in years in which there are no surpluses by cutting other spending, raising taxes, or borrowing.

Investing in the stock market

President Clinton's plan also proposes that some 20% of the $2.7 trillion in new money paid into the Trust Fund be invested in the stock market. Stock holdings would be kept below 14.6% of all Trust Fund assets and would average about 3.4% of the total value of the stock market over the next 50 years (Goss

1999). Because the plan assumes that returns from the stock market would average 6.75%, as opposed to 2.8% from the bonds in the Social Security Trust Fund, the administration predicts that these investments would extend the life of the Trust Fund for an additional six years, to 2055.

Advantages and disadvantages of the president's proposal

The president's plan is a serious answer to the question of how to save Social Security. His proposal provides the assets that the Trust Fund will need in order to maintain the current level of real benefits far enough into the future — 50 years — to satisfy any reasonable standard of projected Trust Fund solvency. It also prepares for future cash needs by proposing to pay down the national debt now, which will give the government of 2014 and beyond another option besides just raising taxes to cover the redemption of the bonds.

But the plan has several flaws. First, devoting a large part of the federal budget over the next 15 years to Social Security and debt reduction means that other pressing public needs will continue to be ignored and that discretionary domestic spending will be insufficient to provide an adequate level of services — particularly when combined with the increased military spending that the president and congressional Republicans favor. Inasmuch as domestic federal spending tends to redistribute resources to low- and middle-income people, these proposed discretionary spending restrictions mean that the needs of lower-income Americans will be sacrificed now for the benefit of retired Americans two decades from now, whose incomes will be substantially higher. Moreover, public investment in education, training, infrastructure, and technology — necessary to assure a healthy economy in the first half of the 21st century — will not be made, reducing future incomes and making the future burden on taxpayers greater than it would otherwise have been.

Secondly, the returns from investing Trust Fund holdings in the stock market have been overestimated, especially given the Social Security trustees' projections for a slowdown in economic growth (an important factor in Social Security's projected shortfall). A more consistent projection of returns does not justify the relative risks and potential hazards of investing Social Security funds in the stock market.

This over-estimation results from the Clinton Administration's expectation that future returns will mirror past ones. Over the past 75 years, the inflation-adjusted, annual rate of return on stocks averaged 7%. The Clinton proposal assumed an only slightly more modest future return of 6.75%. But if the Social Security trustees are correct in their projection of a slowdown in economic growth, profit growth will also slow. If profits slow down, so will stock market returns. An expectation of returns on stock consistent with the trustee's projections would average about 3.5% (U.S. treasury bonds are projected to average about 2.8%). So not only are the likely returns on stock only slightly higher than those on bonds, but the risks from investing in stocks are far greater. With stocks there is a real possibility of unwise or unlucky investments and stock market downturns.

If, on the other hand, the Social Security trustees are wrong and growth for the next 75 years equals growth from the last 75 years, then one-third of the projected shortfall disappears anyway. In that case, the added revenue from investing in the stock market — along with the added risk — is no longer needed. Finally, there is the potential for government investment in the stock market to distort the goals of national economic policy. To the extent that maintaining Social Security payments requires the national government to bet on a rising stock market, then a rising stock market will tend to become a more important objective of economic policy than keeping the unemployment rate low, for example. The interests of those whose primary income comes from investing in the stock market and the interests of working

Americans are not always the same. Indeed, it has become commonplace to see Wall Street greet a rising unemployment rate as good news. A majority of Americans are better off if full employment rather than a higher Dow Jones is the primary objective of economic policy.

In broad outline, the Clinton proposal has much to recommend it. But it could be improved first by dropping the proposal to invest part of the Trust Fund in stocks, and second by using 33%, not 66%, of the surplus for Social Security, with the remainder to be used for Medicare, investments that promote future economic growth, and other areas where needs are going unmet. Increased revenue from removing the cap on earnings subject to the Social Security payroll tax could make up the difference in revenue.

Privatization proposals

A recent proposal by Martin Feldstein and Andrew Samwick (1998) has received much attention and is illustrative of the privatization alternatives supported by most congressional Republicans. It differs primarily in that individual accounts will be funded by the federal budget surplus, not out of existing payroll tax revenues. Feldstein and Samwick argue that their plan would eliminate the long-term shortfall in the Trust Fund with no changes in benefits or taxes. This proposal, however, is based on assumptions that are much more flawed than the president's and would translate into either inadequate trust fund reserves or increased costs to taxpayers and the federal government.

Under the Feldstein-Samwick plan, the federal government would contribute the equivalent of about 2% of each worker's earnings (below the cap on income subject to the payroll tax) to an individual account. These contributions would be funded by the federal government surplus. When a worker reached retirement age, his account would be converted into an annuity. For each dollar of retirement income benefits received from the annuity, the retiree's Social Security benefits would be reduced by 75 cents. Feldstein and Samwick claim that the reduction in outlays from the Social Security Trust Fund would extend its life beyond the 75-year planning horizon.

The Feldstein-Samwick plan has four fundamental problems.

- *The plan overestimates the rate of return that would be earned on individual accounts.* Feldstein and Samwick estimate that an individual account (with an assumed investment mix of 60% stocks and 40% bonds) will earn an inflation-adjusted average annual return of 5.5%, "the average return on [such a portfolio] during the postwar period through 1994." But the expected slowdown in economic growth projected for the future will reduce the returns on the portfolio described by Feldstein and Samwick to about 3.5%, not 5.5%. To reach the same level of savings one would accumulate from an initial investment of 5.5% held over 35 years, a worker with a portfolio earning 3.5% would need a contribution of 3.9% of earnings (nearly double the 2% estimated by Feldstein-Samwick). This plan therefore does not cover the Social Security deficit, and would require either increased taxes, reductions in other federal spending, or expanded budget deficits.
- *Investing in the stock market through a system of individual accounts is much more expensive than investing directly through the Social Security Trust Fund.* Annual administrative fees of 1% to 2% of the value of each account would significantly reduce accumulations and the money available to be paid out in benefits. Converting the individual account into an annuity would cut the value another 15% to 20%. The savings to the Social Security Trust Fund would be reduced by the same amount.

  Under a privatized Social Security system in Chile, administrative costs eat up 15% to 20% of

workers' pensions. In Great Britain, costs are running above 40%. In contrast, administrative costs of the U.S. Social Security system are less than 2% of contributions.

- *The plan increases the possibility of fraud and abuse.* Individual accounts that permit account owners to place their money in a wide range of investment vehicles raise the likelihood of fraud and abuse in the sales of stock. Arthur Levitt, chairman of the Securities and Exchange Commission, has noted that "[a] system of self-directed individual accounts would require an unprecedented level of broad-scale policing of the equity markets. Otherwise, fraud and sales practice abuses could be perpetrated against society's most vulnerable investors" (*Washington Post*, November 16, 1998). Levitt reports that in England, reform of the retirement system and creation of individual accounts led to "billions of dollars in losses for investors" through fraud and other abuses.
- *The plan encourages risky investments.* Workers are guaranteed basic Social Security benefits under this plan even if they lose all the money in their individual account through poor investments. Workers receive only one-quarter of the gains made on an individual account since, for every dollar received, 75 cents is given up in basic Social Security benefits. Because there is just a small penalty for investment losses while very big investment gains are required to produce any noticeable rise in retirement income, risky investments (which have a high potential for large losses but also for large gains) will be very attractive.

Decisions about the future of Social Security must not be based on overestimates of future returns in the stock market nor on a less-than-complete understanding of the added costs and risks associated with individual accounts. If the country decides that it is appropriate that workers' core retirement money — Social Security — be invested in the stock market, then the most efficient way to accomplish this goal would be through the Trust Fund, as the president proposes.

Conclusion

The essential problem facing Social Security is less dire or complicated than it may seem from the hyperbole produced by the current debate.

The fact that people will live longer than their parents is a cause for celebration. And the obvious implication — that they will spend more time in retirement receiving Social Security and therefore have to pay a little more in taxes to support the program — should not be unbearable for most voters to accept.

Unfortunately, neither the White House nor congressional leaders seem to be willing to make this simple, honest case to the people.

Given that reality, the president's proposal, though far from ideal, at least offers a logical strategy for strengthening Social Security.

The Republican congressional proposals to privatize the program by providing individual accounts do not seriously address the problem. Privatization is a reckless gamble, vastly increasing the chances of impoverishing large numbers of retired Americans in the first part of the 21st century.

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Endnotes

1. This date will probably be extended further into the future based on the trustees' new report.

2. The president also proposes that 12% of the 15-year federal budget surplus, or $536 billion dollars, be used to fund Universal Savings Accounts (USA accounts) to boost lower-income workers' retirement income. This would provide an opportunity for lower-paid workers to create private pensions but would have no effect on the Social Security program.

References

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