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The Social Security Time Bomb

By Edward A. Sprague

Economist Paul Samuelson once referred to the social security system as a perpetual Ponzi game. Those in the work force would willingly contribute mushrooming sums to the support of the disabled and retired in the expectation that they will get their share — and, hopefully, a lot more than their share of past contributions — in future benefits. Samuelson was not troubled by this, having faith in the continued real growth of the economy to justify these expectations. In looking at the well-advertised problems of social security, one might conclude that Samuelson's description was accurate, but that the system will end up just like Ponzi — busted.

That *could* happen. In fact, if nothing is done to change social security and economic conditions do not improve swiftly, it will happen quite soon — specifically, between July and November, 1982 — for the Old Age and Survivors' Insurance Fund. It's not likely to happen that soon because both the Hospital Insurance and Disability Insurance funds are in much better shape than OASI, and everyone is now assuming that there will be some swapping around or borrowing between these funds to keep them afloat over the short term. But there's no assurance that even complete commingling of the funds, which would take some legislative effort, will provide enough cushion for the 1980s. The next crisis point may well be 1984-85. After the early 1990s, according to economic projections and counting on the higher tax rates under the schedule of existing law, there should be an approximately 30-year breathing spell. Along about 2020, the system will face an even more serious crunch because the baby boom generation of World War II will be retiring, and, with the expectation of continuing low birth rates, there just won't be enough workers to support them in the style of the present.

Long-term imbalances in social security financing have been foreseen for years. But now, again, there are two fuses on the social security time bomb — short and long. Both must be defused. Furthermore, we can't be complacent about the 21st century just because it's still a long way off. The most sensible and nonexplosive steps to solve the long-term problem will have to be initiated within this decade.

The 1980s

The table on page 6 capsules in the simplest manner possible the relatively grim outlook for the social security system over the next few years. It shows the projected fund assets at the beginning of each year as a percentage of payments (outgo) during that year for OASDI, HI, and the total. The HI fund is much smaller, of course, so that the relatively comfortable asset coverage in that fund during the period ahead only mitigates the situation with respect to OASDI, assuming commingling of funds. Anything less than

This Issue In Brief

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Assets at Beginning of Year as a Percentage of Outgo During Year[a]

Year	OASDI	HI	Total
1979	30	54	34
1980	24	54	29
1981	18	52	23
1982	9	63	18
1983	2	72	14
1984	−4	78	10
1985	−10	81	7
1986	−14	79	4
1987	−16	78	3
1988	−14	76	5
1989	−13	68	5
1990	−14	53	2

[a] Under present law, on the basis of a slow recovery cycle economic assumptions, calendar years 1979-90.

Source: Social Security Administration, Office of the Actuary, November 12, 1980, and Congressional Research Service, Library of Congress.

one month's leeway (8.3 percent of assets to a year's outgo) must be considered the crisis stage.

According to the above calculation and assuming no legislative changes, the OASDI funds will be in dire straits in 1983 and in deficit after that. The total system will be in imminent danger of going broke from 1985 on. If these percentages do not look all that significant, remember that by the mid-1980s we're talking about total tax receipts and trust fund expenditures of close to $300 billion per year.

The projections are based on the mid-1980 economic assumptions of the Carter Administration blended with the intermediate economic forecast of the Trustees of the social insurance funds and then adjusted by the Congressional Research Service for a somewhat slower economic recovery in 1981-84 and another recession around 1985. This appears to be a more realistic outlook than just extrapolating a continuing improvement in employment conditions and inflation as under the Carter Administration projections. But it is by no means the most pessimistic.

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Others have foreseen things falling apart even quicker with the potential for multibillion dollar fund deficits for the system by 1984.

Digging Out

Much of the past discussion on what to do about social security has centered on finding an alternative financing source. The 1977 changes, which upped payroll tax rates and quite drastically raised the wage base over and above the scheduled automatic increases, were *supposed* to see the system through to the 21st century. They obviously won't, but it's generally agreed that we have run out the string on further payroll tax increases if, in fact, we can stick to the ones scheduled under present law. In 1981, any worker making $29,700 or more will be "contributing" directly $1,975—his or her employer a like amount. If the scheduled tax hikes are allowed to stand (and these are built into the fund projections, of course), the maximum tax on employee/employer each will go to at least $2,898 by 1985, rising by an annual average of 13 percent per year for the 1980-85 period. Even sharper increases will be in store for many workers under the maximum now whose wage level rises with inflation. Overall, the percentage of covered earnings subject to the payroll tax is going over 90 percent this year, far higher than contemplated earlier when social security was considered a minimum base for retirement. Looking down the road, under the "intermediate" economic assumptions, which many feel are too optimistic, the total employee/employer tax would have to rise to over 25 percent to keep the system afloat in 2030.

Little wonder then that there has been so much talk of general revenue financing for part of the system and even of finding a new broad-based Federal tax source as a substitute for payroll taxes. But other unpleasantries keep intruding. There simply are no spare general revenues, whether or not it would be desirable to separate out the more welfare-oriented elements of social security from the payroll system. There certainly are not likely to be any spare general revenues before the funds could run dry in the mid-1980s. A Federal value-added tax or national sales tax for this purpose is about as popular as a snake in the swimming pool.

The Benefit Structure

This brings us back more forcefully to the benefit structure and how we got into the financing pickle in the first place. A spate of recent studies of social security, including the regular Advisory Council, a special Congressional Commission, and various private sector efforts, all have come to the same general conclusion that the benefit structure must have a major overhaul. While some still favor general revenue financing of parts of the program, there is much more widespread recognition of the real problem. The real problem is simply that a benefit structure has been designed to meet continually rising expectations as to the economy's ability to support it. The most glaring example of this was the adoption of so-called "dynamic" actuarial assumptions as to the employment and tax base back in 1972, which then "justified" a 20 percent boost in benefits and the initiation of automatic inflation indexing of benefits. Some say the Ponzi game really started way before at the inception of social security in the 1930s. Social security was advertised as an insurance program giving the impression that "contributors" to the program had contractual rights to future benefits. There is not now, and never has been, any such contract between the government and an individual worker. The program is plainly an income transfer system — working age to old age. There is no "insured" benefit other than the expectation that the government will continue the schedule of benefits even if it has to print money to do it. For years, this seemed like a reasonable bet, and the system grew like Topsy.*

Setting Priorities

Some critics of social security still believe the ultimate solution is a legitimately funded insurance program. In the 1930s, this didn't look like a very good idea with the economy flat on its back and not much concern about the potential effect on savings and capital formation, etc. Now, it still doesn't look very practical. Not that we don't need the additional savings, but what do you do with the trillions of dollars in unfunded liabilities? Tax rates to fund fully the future obligations (not contracts, but obligations) of those workers covered by social security would be astronomical. Thus, we are probably stuck with the income transfer system and the basic payroll tax financing. This doesn't mean that we can't deflate some of the expectations as to benefits and move them more in line with more realistic assumptions as to the economy's employment and tax base. To put things in order through the 1980s, we could do several things:

1. *End the overindexing of benefits which has contributed so to the bulge in payments in recent years and projected for the future.* CPI indexing of current benefits significantly overstates the real effect of inflation on retirees. If a more accurate indexing method were used, savings of almost $3 billion per year could be made immediately. If the inflation adjustment were restricted to *less* than a full percentage of increase in the inflation index or the interval of adjustment stretched out some, many more billions could be saved. This could be accomplished probably only by applying it across the board to all indexed transfer programs. Certainly social security beneficiaries should not take the brunt alone. Finally, and of much more importance for the long term, the indexing method to set the initial level of future benefits of those now working should be changed from a wage base to a price base or whichever is lower. Because, historically, wages have increased faster than prices, the wage base adjustment tends to overindex initial benefits. It includes the economy's productivity advance as well as general inflation in benefit levels. Most observers agree this should be changed, although the Social Security Advisory Council still has not gone along with this specific recommendation.

2. *Make the quite reasonable benefit adjustments proposed by the Carter Administration in 1979 to cut the special student benefit, which is largely duplicated by other Federal programs, the payments to surviving spouses with working-age children, the lump sum death benefit, and to make changes in the minimum payment.* Together, this package could save over $3 billion a year in the mid-1980s.

3. *Tax social security benefits.* Including benefits over and above the payroll taxes paid by individuals in the taxable income of beneficiaries could raise about $5 billion in additional revenues at current levels. This has been proposed on the grounds that the employer-provided share of benefits is tax free and that most retirees have enjoyed a windfall transfer of income — paying much less into the system than they are getting out of it. However, the maturing of the system means that the future retirees will get less in the way of windfall, and those born after the early 1950s will probably end up with substantial real losses (compared to what they could get under inflation-adjusted annuity plans). Further, many would argue that the employer's share of social security taxes is really paid by the workers anyway in the form of lower wage income than otherwise would be the case, weakening the case for subjecting future benefits to income taxes. A more equitable arrangement

*While the Federal social insurance programs have never been "funded," until the mid-1970s substantial surpluses were being accumulated; and these were utilized to "bank" Federal securities which otherwise would have had to be monetized or added to debt held by the public. In this sense, the operation of the social insurance funds in the 1940s to 1960s was an important anti-inflationary influence. Now, of course, the situation is reversed with outflows exceeding tax receipts and fund balances being drawn down—another reason for the increasing pressures on the debt markets.

might be to allow those working to deduct the cost of payroll taxes, a real and rising burden at all income levels, from their income taxes and tax benefits received later on in retirement, presumably at much lower marginal rates — an expansion of the IRA concept to almost everybody. This might be fairer, but it would probably wash out any cost savings to the system and certainly wouldn't help the fund balances currently.

4. *Mandate universal coverage.* This has been proposed often as a means of gaining additional revenues while eliminating the double-dipping of Federal employees who take private sector jobs and qualify for social security in addition to civil service retirement. It would be very difficult to accomplish. At best, it could only be done with full integration with civil service on favorable terms to current Federal employees, diminishing the potential for revenue gains. Further, the temper of the times certainly is against forcing more people onto social security, regardless of their financial or employment situation.

Any reasonable combination of points 1 and 2 above with an economy that doesn't fall out of bed completely should get us through the 1980s without any new tax measures. In fact, they might allow some cutback on scheduled payroll tax increases and/or liberalization of the counterproductive earnings test.

A Long-Term Remedy

For the very long term, one other move is probably necessary — a slight increase in the retirement age. Even a single year's difference could have a very profound effect on fund balances in the 21st century. Depending on what is done about indexing, it need not necessarily be as great as postponing retirement from 65 to 68, proposed in a number of studies. It would not significantly affect the retirement plans of the bulk of the current work force and need not affect those age 45 and over at all. There would have to be, however, agreement to implement such a plan many years before it went into effect. We could not just wait until the year 2000 and spring it on the populace.

It is often said that cutting back on broad-gauge transfer programs, such as social security, is politically impossible with Congress so responsive to spending constituencies. Lopsided votes against certain attempts to tighten up are cited. But now awareness of the serious nature of the problem is spreading outward from academic projections. There's nothing like the prospect of a broke retirement system to focus attention. Actually, some limited corrective steps have already been taken, such as eliminating the double indexing factor in 1977. For the most part, the measures outlined above are hardly radical reforms. In the course of things, some of them should not be all that difficult to implement given the overriding concern to keep the system intact. The beneficiaries of the system certainly have the greatest interest in keeping it intact.

Lowering Expectations

More is involved, of course, than just saving fiscal balance. There is no doubt that unchecked expansion of Federal social insurance programs is undermining both the individual and institutional structure of private savings so essential for our capital formation needs. Studies by Martin Feldstein of Harvard University have come to alarming conclusions in this regard. While some technical flaws in his work have been pointed out (and subsequently corrected without modifying the conclusions, according to Feldstein), there's mounting circumstantial evidence that more and more people now are counting on social security as the *major* part of their retirement provision and less and less on individual savings and insurance. Even institutionalized savings under private pension plans—the great growth industry of the 1950s and 1960s—are being affected here. In the inflationary environment of the 1980s, why wouldn't so many workers look on an indexed benefit as more secure for the future than private savings? The trick then is to defuse the financing time bomb, deflate the Ponzi expectations as to future benefits, and, at the same time, keep faith with the commitments that have been made to provide a basic block of income security. In the process, both capital formation needs and the fight against inflation could be well served.