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The Social Security Protection Plan

How we can cope — calmly — with the system's long-term shortfall

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All is momentarily quiet on the Social Security front. So this may be an opportune time to take a calm look at the long-term financing shortfall facing the system.

As everyone surely understands by now, the aging of the babyboom generation will greatly swell the ranks of Social Security beneficiaries over the next 30 years — with the total, including children and disabled beneficiaries, increasing from about 48 million today to about 88 million in 2035. The numbers will continue to grow after that, although more slowly, and are projected to reach 110 million by 2080 — the end-point of the trustees' current 75-year cost estimates, which also assume, with good reason, that the elderly of the future will live longer and thus receive benefits longer than their predecessors.

How should we meet this sharply increasing cost?

Social Security has traditionally had two sources of income: the contributions of workers and their employers plus the investment income earned by the trust funds, which hold the accumulating excess of income over expenditures. Since 1983, when the most recent major amendments were enacted, the program has had a third source of income: taxation of the benefits of higher-income beneficiaries. In 1983 it was estimated that the income from these three sources would meet estimated costs over the following 75 years and leave a reserve equal to about one year's benefits.

Because of changes since 1983 in some of the assumptions governing their long-range projections, Social Security's trustees now anticipate a deficit over the current 75-year estimating period of about 1.9 percent of payroll. It is this long-term shortfall, which I believe should be seen as neither trivial nor overwhelming, that needs to be addressed. Moreover, we should not view the next 75 years as a closed period during which we build up the trust funds and then spend them down again. We need rather to keep building the funds throughout the 75 years so that future earnings on the funds will contribute to financing the system during the current 75-year period and beyond.

We can do the job in three steps—and, very importantly, without further benefit cuts.

1. Restore the maximum earnings base to 90 percent of earnings

Our goal, as before, should be to build up and maintain an invested reserve that can help meet future costs — costs which, if covered on a strictly pay-as-you-go basis, would require a substantial increase in contribution rates (rising from today's 12.4 percent of payroll to an estimated 18.15 percent in 2080 and even more beyond). We should start building the reserve by getting back to the practice of collecting the Social Security tax on 90 percent of all covered earnings, the goal affirmed by Congress in 1983.

Present law contains a provision which was intended to keep the coverage level at 90 percent: an automatic annual increase in the maximum annual earnings base (now $94,200) by the same percentage as the increase in average wages. But this adjustment mechanism hasn't worked as planned, because over the past 20 years the earnings of the higher paid have been rising much more than average wages — so an increasing proportion of earnings exceeds the maximum earnings base and thus escapes Social Security taxation. Today only about 83 percent of earnings is being taxed. That seemingly small slippage translates into billions of dollars in lost revenues each year.

I propose to get us back to 90 percent, but to do so very gradually so that the additional tax on the 6 percent of earners with wages above the cap would increase very little year by year. I would increase the maximum earnings base by 2 percent per year above the increases occurring automatically as average wages rise. Thus, for example, the maximum next year would go up $1,884 (2 percent of $94,200) beyond the automatic increase, and the maximum tax increase beyond present law would be $116.81 ($1,884 times the Social Security tax rate of 6.2 percent). In practice, this would mean that deductions from earnings for the highest-paid 6 percent of workers would simply continue for a few days longer into the year, while for the 94 percent of covered workers with earnings below the cap there would be no change at all.

With this approach it is estimated that we would get back to the 90-percent level in about 40 years. Such a gradual adjustment would be virtually painless — but this seemingly small change would reduce the projected 1.9 percent of payroll deficit by almost a third, to about 1.3 percent of payroll.

We could, of course, speed up the timetable in order to reach the 90-percent level sooner — in, say, 10 years instead of 40. That would reduce the deficit a bit more (just over 0.1 percent of payroll), but because it would require adding 8 percent rather than 2 percent per year to the automatic adjustment we would substantially increase the burden of taxation on workers earning not much above the present maximum. For example, someone earning only $7,500 above the cap next year would pay an additional tax of $465. The slower timetable accomplishes nearly as much deficit reduction without such sharp increases in cost for anyone.

2. Earmark the estate tax for Social Security

In addition to restoring the taxable earnings base, I propose to establish a new source of funding by changing the estate tax into a dedicated Social Security tax beginning in 2010.

Present law gradually reduces the estate tax so that by 2009 only estates valued above $3.5 million ($7 million for a couple) will be taxed. President Bush then wants to abolish the estate tax permanently from 2010 on. Instead, I would freeze the tax at the 2009 level and earmark the proceeds for Social Security from 2010 on, thereby converting the residual estate tax into a dedicated Social Security tax just like the tax on employers' payrolls.

Such a tax would be an appropriate way to partially offset the deficit of contributions that was unavoidably created in Social Security's early years. At that time the sensible decision was made to pay higher benefits to workers nearing retirement age than would have been possible had their benefits depended entirely on the relatively small contributions that they and their employers would have had time to make.

Like most of the founders of Social Security, I once assumed that general revenues would eventually be used to make up for this initial deficit of contributions. The idea still makes sense, since there is no good reason why the cost of getting the system started should be met entirely by the future contributions of workers and their employers. But there are no general revenues available because the president's policies have resulted in projections of deficits rather than surpluses as far as the eye can see. Therefore I favor substituting for general revenues this new dedicated Social Security tax based on the residual estate tax, which otherwise appears destined for repeal.

I believe we will have to earmark the estate tax in order to save it. And we should. Carving a modest tax on large estates out of general revenues, to help pay off part of the cost of establishing a universal system of basic economic security, would be a highly progressive way to partially offset the original deficit of contributions.

Moreover, to allow the transfer of huge estates from one generation to another without paying a tax to the common good is undemocratic in principle (as Tom Paine, among other early advocates of an inheritance tax, recognized). And an analysis by the Congressional Budget Office found that a $3.5-million exemption would protect against the risk of having to break up small family farms or businesses in order to pay the tax.

This change reduces Social Security's projected long-term deficit by about 0.5 percent of payroll. When combined with restoration of the earnings base, it cuts the projected deficit slightly more than in half, to 0.8 percent of payroll.

These two changes bring the deficit to the outer margin of close actuarial balance — that is, the point where income and costs are projected to be within 5 percent of each other over 75 years. The concept of close actuarial balance, which recognizes the impossibility of making exact forecasts so far into the future, has long been used by Social Security's trustees to help determine whether financing changes are needed. The cost of the program today is estimated to average about 15.8 percent of payroll over the next 75 years, so a deficit of about 0.8 percent of payroll would just meet the close actuarial balance test, using the trustees' middle-range estimates.

Although I favor judging the adequacy of long-range financing according to the trustees' projections, it should be noted that the Congressional Budget Office anticipates a long-term deficit only about half as large as the deficit forecast by the trustees. Thus these two changes alone might well be sufficient to bring the system into long-term balance according to CBO's assumptions.

3. Invest in equities

To further strengthen Social Security's financing and bring the system well within close actuarial balance for the next 75 years (based, as noted above, on the trustees' middle-range estimates), I would diversify the trust funds' investments — putting some of the accumulated funds into equities, as is done by just about all other public and private pension plans. Several other government-administered programs (including part of the Railroad Retirement program as specifically authorized by Congress) already make such direct investments in stocks, as does Canada's social insurance system. There is no good reason to continue to require Social Security to invest only in low-yield government bonds.

Investment of a portion of Social Security's assets in stocks should be done gradually. I would propose

starting with 1 percent in 2006, 2 percent in 2007, and so on, up to 20 percent in 2025 and capped at that percentage of assets thereafter, with investment limited to a very broad index (such as the Wilshire 5000) that reflects virtually the entire American economy. A Federal Reserve-type board with long and staggered terms would have the limited but important functions of selecting the index fund, selecting the portfolio managers by bid from among experienced managers of index funds, and monitoring and reporting to the trustees and public on Social Security's investments.

Among other things, reliance on a board with long and staggered terms will guard against any risk that Social Security's investments could become subject to political manipulation. Social Security would not be allowed to vote any stock or in any other way influence the policies or practices of any company or industry whose stock is held by the index fund. (In any case, there would be no more reason to expect government interference under this plan than under President Bush's proposal, which would give government the responsibility for investing the individual accounts he advocates. So the argument against letting Social Security invest in stocks because of the alleged risk of market interference has lost some traction lately. But the more important point is that concerns about political interference can be addressed by limiting the amount of assets invested, requiring passive investment in a total-market index fund, and providing for oversight by a board structured to ensure its impartiality and autonomy.)

Investment by the trust funds has a major advantage over individual investment account proposals. Investing one's basic retirement funds in stocks is very risky for individuals because, among other reasons, they will ordinarily need the money upon retirement, and in order to be sure of making the income last until death will need to buy an annuity with the proceeds. But that could mean having to sell stocks and buy an annuity during a market downturn. As Gary Burtless of the Brookings Institution has demonstrated (by examining what would have happened if an individual-accounts system had been in effect in the past), timing is everything. A variation of just a few years — even months — in the time of buying an annuity can make a huge difference in its value. In contrast, investment by the trust funds is largely protected against this risk, since Social Security would be able to ride out market fluctuations.

As with the investments of a private retirement plan, the goal of trust fund investing would be to build up and hold on to a reserve whose earnings would help meet future costs. This proposal is estimated to save about 0.4 percent of payroll. When combined with the other two changes outlined above, it brings the 75-year deficit anticipated by the trustees to an estimated 0.4 percent of payroll, well within the range of close actuarial balance.

It bears emphasizing that all three of these proposals are desirable in themselves regardless of their importance in reducing the long-range deficit. And if their adoption should result in overfinancing the program, it would still be desirable to enact them — and then provide for a reduction in Social Security tax rates.

At the same time, it is important to ensure that the build-up of the trust funds is maintained so that earnings on the funds continue to contribute to future financial stability during and beyond the current 75-year estimating period. I therefore favor providing for a contribution rate increase that may or may not be needed, depending on the accuracy of the long-range estimates. With this approach the law would provide that if short-term estimates showed that the trust funds would begin to decline within the next five years, a tax rate increase would go into effect to prevent such a decline. If the need for this increase were to occur before the maximum earnings base had been restored to fully cover 90

percent of earnings, I would accelerate the timetable for restoration of the base and then determine whether there is still a need for the tax rate increase.

And there are other potential sources of income that would make it less likely to need a rate increase to prevent a decline in the trust funds' assets from the maximum achieved. If, for example, Social Security coverage were to be extended, as it should be, to all newly hired state and local government employees, the 75-year deficit anticipated under the middle-range estimates would be reduced by about another 0.2 percent of payroll. And adoption of the more accurate Consumer Price Index recently developed by the Bureau of Labor Statistics would result in slight reductions in Social Security's annual Cost of Living Adjustment, thereby saving about an additional 0.4 percent of payroll and bringing the system into full balance over the next 75 years.

It's also possible, of course, that the trustees' middle-range estimates may prove to be too pessimistic and actual experience may be closer to their low-cost estimates. In that case just the three changes that I am proposing to make immediately effective — restoring the maximum wage base, earmarking the residual estate tax as a new dedicated Social Security tax, and diversifying the trust funds' investment portfolio — would be sufficient to maintain the trust funds at the highest point achieved and produce a surplus beyond the next 75 years.

The trust funds: real money

How does this analysis square with President Bush's doomsday proclamations of a current crisis for Social Security? It doesn't. And there is no basis for such alarms, since the middle-range cost estimates — the set on which the trustees depend — show the system able to pay full benefits as defined under present law until 2041.

Although the cost of benefits is expected to exceed income from contributions plus taxes on benefits in 2017, the only way for the Administration to predict a crisis at that point is to ignore the existence of the trust funds and count only contributions and taxes on benefits against the system's costs. To do so, however, requires repudiating 70 years of depending on earnings from a fund build-up invested in United States bonds and held by the trust funds. Most experts believe to the contrary that these bonds held by the trust funds and bought by the dedicated Social Security contributions of the past are protected by the full faith and credit of the United States, just like all other bonds issued by the government.

If the only money available for Social Security payments is to come from current Social Security contributions and taxes on Social Security benefits, then there will be, of course, a big gap between the program's rising costs and its income — a gap which the president would close with benefit cuts so large that they would convert Social Security from a modest retirement and family income protection system for everyone to a narrowly targeted welfare program for very low wage earners. But to predict a near-term crisis requires being able to argue with a straight face that the government cannot keep books — that all previous Social Security contributions have vanished without a trace because the money has been spent on other government programs, with the bonds held by the trust funds meaning nothing at all.

If that's true, the federal government has been lying to workers covered by Social Security for 70 years — and that would be a scandal of staggering proportions. But it's not true.

To be sure, the Social Security contributions of the past have been invested in government bonds — and just as the government has used the money it has borrowed from selling bonds generally, so it has used the money it has borrowed from selling bonds to the Social Security trust funds. And it is true that if the bonds held by Social Security were called in, it would be necessary for the Treasury to borrow money or raise taxes to redeem them — just as would be the case in redeeming any other bonds issued by the government and held by the public.

In practice, however, it is unlikely that Social Security would ever want to cash in the government bonds it will hold. After all, the object is to build up an earnings reserve and use the interest on the reserve to pay benefits, just as is done with private pensions — not build up a reserve and then cash it in again.

A balanced approach

This plan addresses Social Security's long-term shortfall solely by increasing income to the system. Why not achieve balance by trimming benefits too? The problem is that benefits are already being cut in two significant ways — first by changing the retirement age, which alters the benefit formula in a way that has the effect of an across-the-board benefit cut, and second by the ongoing deduction of Medicare premiums from Social Security benefits. So a truly balanced solution to the long-term shortfall must call for more income, not more benefit cuts.

We simply can't afford to reduce the protection that Social Security currently provides. Social Security benefits are the major source of support for two out of every three beneficiaries and are vitally important to nearly all the rest. Benefit levels need to be maintained or even improved, particularly in light of the increasingly uncertain future faced by private pension plans — with traditional defined-benefit plans (many of them underfunded) now covering only about 20 percent of the private-sector workforce, and with the 401(k) individual savings plans that are to some extent replacing the traditional plans subject to the vagaries of individual investment experience and vulnerable to being cashed out before retirement.

It's in this context that we have to assess Social Security's long-term financing challenge. I believe that an accurate assessment can lead to only one conclusion. Radical changes are unwarranted. And the changes I propose are anything but radical. As noted, the first three are desirable in themselves — and vastly preferable to the drastic benefit cuts proposed by the president or the major tax rate increases that would be required in a strictly pay-as-you-go-system.

Perhaps, in this moment of relative calm, we can make the case for common sense.

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