

Strengthening Social Security for the Long Run

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Social Security is America's most successful and – deservedly – most popular social program. It is the base upon which nearly everyone builds retirement income, and has virtually eliminated poverty among the elderly. Social Security is also a family insurance plan, guarding against insecurity and impoverishment as the result of the death or disability of a wage-earner. No other program so clearly makes the United States a better and safer place.

Yet there is widespread public anxiety about Social Security's future. This is not surprising, given the frequency with which the system is described as going broke. For example, a recent *Washington Post* article stated flatly that Social Security will "run out of money by 2040." That statement is simply not true.

What is true is that by about 2040, unless some action is taken in the meantime (as I am sure it will be), Social Security may not have enough money coming in to pay full benefits.¹ But even so, under present law Social Security will not "run out of money" because payments into the system by workers and employers and income from the tax on the benefits of higher income recipients will continue indefinitely.

That same newspaper article, reflecting a widely held view, claims that members of Congress seeking to fulfill their campaign promises to preserve Social Security face only three limited and painful options: "raise taxes, reduce benefits or make Americans wait longer for their Social Security checks."

This dire view is also wrong. The truth is that Democrats and Republicans interested in strengthening rather than undermining Social Security can do so by making some non-burdensome changes which are desirable in any event and which are entirely consistent with the program's goals, *and without cutting benefits*.

First, some key facts:

As just about everyone surely understands by now, the aging of the babyboomers will greatly swell the ranks of Social Security beneficiaries over the next 30 years, with the total nearly doubling from about 48 million today to about 89 million in 2035. The numbers will continue to grow after that, although more slowly, and are projected to reach 110 million by around 2080, toward the end-point of the Social Security trustees' current 75-year cost forecasting estimates.

¹ In their 2008 report, Social Security's trustees estimated that in the absence of changes the Social Security trust fund is likely to be exhausted by 2041, after which revenues will provide only enough money to pay about 78 cents toward each dollar of scheduled benefits.

It is important to note that the challenge of meeting the cost of paying benefits to this largest-ever group of beneficiaries – who are also expected to achieve greater longevity than any prior generations – did not catch Social Security’s long-range planners by surprise. They recognized the challenge and were planning for it when the babyboomers were still 30 to 40 years away from retirement. And they are well aware that the system will continue to require financing at historically unprecedented levels even after mortality has claimed the last of the babyboomers.

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 that hold the accumulating excess of income over expenditures. In 1983, when the most recent major amendments to the program were enacted, a third source of income was added: taxation of the benefits of higher-income beneficiaries. At that time, the income from these three sources was projected to cover estimated costs over the next 75 years – in other words, to meet the full cost of the babyboomers’ retirement.

However, because of changes since 1983 in some of the assumptions from which the long-range projections are derived, Social Security’s trustees now anticipate a deficit over the current 75-year estimating period of about 2 percent of payroll. It is this *shortfall* – not trivial but not remotely synonymous with “going broke” – that must be addressed.

In doing so, we should not treat the next 75 years as a finite period of time during which we arrange to build up the trust funds only to then spend them down again. Instead we should make changes that will keep building the funds so that future earnings on the invested reserve will contribute to financing the system beyond the current 75-year estimating period. Otherwise, in the absence of such a reserve, we would have to substantially increase contribution rates from today’s 12.4 percent of payroll to an estimated 17.8 percent in 2080 and even higher after that. Building and maintaining the reserve, therefore, should be an essential part of any strategy to strengthen the system.

We can bring the system into close actuarial balance – that is, the point where income and costs are projected to be within 5 percent of each other over the next 75 years – with just three modifications of present law. And, at the risk of repetition, it is very important to emphasize that we can do the job without more benefit cuts.

1. Restore the Maximum Earnings Base to 90 Percent of Earnings

We should start by restoring the practice of collecting the Social Security tax on 90 percent of earnings in covered employment – the traditional goal reaffirmed by Congress in 1983.

Present law contains a provision that was intended to maintain the coverage level at 90 percent: an automatic annual increase in the maximum annual earnings base by the same percentage as the increase in average wages. But this adjustment mechanism (which raises the taxable-earnings cutoff point to \$106,800 in 2009) has not worked as planned, because during the past two decades earnings at the top of the economic ladder have risen much more than average wages – so a steadily 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 revenues lost to the system each year.

We need to get back to the 90-percent coverage level, but I propose to do so very gradually, so that the 6 percent of earners with salaries above the cap would be required to pay only slightly more from year to year.

This can be accomplished by increasing the maximum earnings base by 2 percent per year above the increases occurring automatically as average wages rise. Thus, for example, the maximum in 2009 would go up by \$2,136 (2 percent of \$106,800) beyond the automatic increase, and the maximum tax increase beyond present law for an employee would be \$132.43 (the Social Security tax of 6.2 percent times \$2,136). In practice, this would mean making deductions from earnings for the highest-paid 6 percent of workers for a few days longer into the year (and their additional contributions would of course be credited toward somewhat higher benefits). For the 94 percent of covered workers with earnings below the cap, there would be no change at all.

With this approach we would get back to the 90-percent coverage level in about 35 years. Such a gradual adjustment would be virtually painless – but this seemingly small change would reduce the projected shortfall by nearly a third, from 2 percent of payroll to about 1.3 percent of payroll.

We could, of course, speed up the timetable in order to reach the 90-percent level sooner – let's say in 10 years instead of 35. That would reduce the deficit a bit more (to slightly less than 1.3 percent of payroll) but because it would require adding 8 percent rather than 2 percent per year to the automatic adjustment, we would be substantially increasing the burden of taxation on workers who earn not much above the present maximum. For example, someone earning only \$7,500 above the cap next year would have to pay an additional tax of \$530. The slower timetable accomplishes nearly as much deficit reduction but without sharply increasing taxes for anyone.

2. Earmark the Estate Tax for Social Security

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

President Bush won a change in the law that gradually reduced the estate tax so that in 2009 only estates valued above \$3.5 million (\$7 million for a couple) are to be taxed. Under current law the tax is scheduled to end entirely in 2010, and lawmakers will debate whether to make that change permanent. Rather than doing so, we should 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 a fair way to partially compensate for the deficit of contributions that was created in Social Security's early years. At that time the sensible decision was made to pay higher benefits to workers reaching retirement age than would have been possible if the amount of their benefits had depended entirely on the relatively small contributions that they and their employers would have had time to make. But this decision – although it was the right one for Depression-era workers and for the economy – created a 'legacy cost' that future generations would have to address.

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. In principle

that idea still makes sense, since there is no good reason why the cost of getting the system started should be met solely by the contributions of workers and their employers. But there are no general revenues available for this purpose today because the nation currently faces deficits far into the future. So it makes sense to substitute for general revenues this new dedicated Social Security tax based on a residual estate tax that otherwise might well be dropped altogether.

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 legacy cost. Moreover, to allow the transfer of huge estates from one generation to another without requiring a contribution to the common good is undemocratic in principle. Although the accumulation of large estates may in many cases be largely attributable to the hard work of the estate owners, wealth also derives from the general productivity of the American economy and its infrastructure. No one gets rich entirely on his or her own. Thus, a tax for the common good is a reasonable payback for the common contribution to estate-building.

Opponents of even a residual estate tax have advanced the emotionally charged argument that such a tax forces those who inherit farms or small businesses to sell them in order to pay the tax. This claim has proven to be largely bogus, and a Congressional Budget Office study found that the \$3.5-million exemption almost totally protects against any such risk.

Changing the residual estate tax to a Social Security tax 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 0.9 percent of payroll.

These two changes bring the deficit within sight of close actuarial balance – 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 them determine whether financing changes are needed. According to the trustees' middle-range assumptions, the cost of the present program is estimated to average about 15.9 percent of payroll over the next 75 years, so a deficit of 0.9 percent of payroll would almost fall within the definition of close actuarial balance (since 5 percent of 15.9 percent of payrolls is about 0.8 percent of payrolls).

3. Invest in Equities

Even though the two changes described above would bring the system very nearly to close actuarial balance, we should further strengthen Social Security's financing by diversifying trust fund investments, which are now limited to low-yield government bonds. Some of the accumulated funds should be invested in equities, as is done by just about all other public and private pension plans. Several other government programs – such as the pension programs for the employees of the Federal Reserve and the Tennessee Valley Authority – already make such direct investments in stocks, as does Canada's social insurance system.

Investment of a portion of Social Security's assets in stocks should be done gradually. I recommend starting with 1 percent during the first year, 2 percent in the second, and so on, up to 20 percent and capped at that percentage of assets thereafter, with the funds invested only in a very broad index fund (such as the Wilshire 5000) that reflects virtually the entire American economy. A Federal Reserve-type board with long and staggered terms should be created and assigned the limited but important functions of selecting the index fund, selecting the portfolio overseers by bid from among experienced managers of index funds, and monitoring and periodically reporting to the trustees and public on Social Security's investments.

Among other things, reliance on an independent board with long and staggered terms would guard against any risk that Social Security's investments could become subject to political manipulation, as some opponents of this change ostensibly fear. 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.

(It should be noted, however, that there would be no more reason to expect government interference in the stock market under this plan than would have been the case under President Bush's privatization proposal, which would have had the federal government responsible for investing the individual accounts that he advocated. So the argument against letting Social Security invest in stocks because of the alleged risk of market interference may have lost some partisan traction. But the key point is that concerns about political interference, whether warranted or not, can be successfully 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 investment by individual accounts. For an individual it is very risky to invest one's basic retirement funds in stocks because, among other reasons, he or she 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 even a few months in the time of buying an annuity can make a huge – even potentially devastating – difference in its value. In contrast, investment by the trust funds carries no such risk because Social Security as a whole could ride out even substantial market fluctuations.

As with the investments of a private retirement plan, the goal of trust fund investing would be to build up and maintain 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 0.5 percent of payroll, well within close actuarial balance.

Fail-Safe Funding

It bears repeating that all three of these proposals are desirable in themselves regardless of their importance in reducing the long-range deficit. And even if their

adoption were to result in overfinancing the program, it would still be desirable to enact them and then provide for an increase in benefits or a reduction in Social Security tax rates when it became clear that the system was overfinanced.

Similarly, it would be a good idea to provide for a contingency contribution-rate increase. As noted, a major objective in strengthening Social Security's financing is 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 beyond the current 75-year estimating period. Thus it makes sense to provide for a contingency contribution-rate increase that may or may not be needed, depending on how closely experience follows the estimates.

If, despite adoption of the three changes outlined above, the trustees were at some point to project that the trust funds would begin to decline within the next five years, the contingency rate increase would go into effect automatically to prevent such a decline. (In the unlikely event that the projected decline were to occur before the maximum earnings base had been restored to fully cover 90 percent of earnings, the timetable for restoration of the 90-percent base could be accelerated, possibly obviating the need for the contribution-rate increase.)

It should also be noted that there are other financing changes that could be used to address the long-term shortfall, making it less likely that the contingent tax increase would have to be triggered. For example, adoption of the more accurate chained Consumer Price Index developed by the Bureau of Labor Statistics (and which at some point may well be adopted in any case) would result in slight reductions in Social Security's annual Cost of Living Adjustments, thereby saving an additional 0.5 percent of payroll. This would bring the system into full 75-year balance according to the trustees' middle-range projections. And if Social Security coverage were to be extended, as it should be, to all newly hired state and local government employees (a portion of whom are the only sizeable group not now covered), the 75-year deficit anticipated under the middle-range estimates becomes a surplus of 0.1 percent of payroll. My assumption is that these sensible changes will be made before any contribution rate increase would need to be considered.

It is, of course, possible that because of productivity increases greater than currently assumed or other favorable changes in the economic or population assumptions, 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, also, it might not be necessary to have a rate increase. If actual experience, however, turns out to be close to the middle-range estimates, then, under this plan, a contribution rate increase would occur automatically so as to build up the trust fund indefinitely into the future.

The point of providing for a contingency rate increase is to address two points about Social Security's long-range financing: first, the inherent uncertainty of any long-range estimates and, second, the undesirability of overfinancing – which, of course, would have the effect of keeping benefits lower than they could be or keeping Social Security contributions higher than necessary. Maintaining a build-up of the trust fund avoids having to move to the ultimately high rate of a strictly pay-as-you-go system while providing just enough financing to pay full benefits.

Later on, as the proposals discussed here have a greater and greater effect, the Social Security trust funds will own an increasing proportion of the government debt, thereby reducing what the Treasury would otherwise owe to private institutions and the general

public. Paying interest to Social Security will be no more burdensome than paying the interest that would otherwise be paid to other bond holders, and at the same time Social Security will be supported in part by earnings on these bonds and its other investments.

The table below summarizes the effects of the changes described above:

Bringing Social Security into Long-Range Balance

	Percent of payroll
Starting point: projected 75-year deficit	- 2.0
Deficit-reduction steps:	
1. Gradually restore the maximum taxable earnings base to 90% of covered earnings	+ 0.7
2. Change the residual estate tax into a dedicated Social Security tax	+ 0.5
Subtotal for 1 and 2	+ 1.2
Reduces deficit to edge of close actuarial balance (<0.8% of payroll)	- 0.9
3. Invest some of the trust fund assets in stocks	+ 0.4
Subtotal for 1 through 3	+ 1.5
Reduces deficit to well within close actuarial balance	- 0.5*
Additional deficit-reduction options:	
• Adopt a more accurate cost of living measure	+ 0.5
• Extend coverage to newly hired state and local employees	+ 0.2
Balance	+ 0.1

* Because of rounding, the numbers throughout do not necessarily add.

Source: Estimates by the Office of the Actuary, Social Security Administration, based on the middle-range estimates of the 2006 Trustees Report.

A Balanced Approach

The three-point plan outlined here addresses Social Security's long-term shortfall solely by increasing income to the system. Why not cut benefits too?

There are two important reasons why benefit cuts should be firmly ruled out. First, benefits are already being cut as a result of gradually increasing the retirement age, which has the same effect as an across-the-board benefit cut.² So a truly balanced approach to meeting the long-term shortfall must call for more income, not more benefit cuts.

² Benefits are also being reduced, of course, by deducting Medicare premiums from them, and will be further reduced by scheduled reductions in the percentage of prior earnings that benefits replace. Today Social Security benefits at age 65 for the average worker are 42 percent of recent earnings without counting the deductions for Medicare. With such deductions counted, the replacement rate falls to 39 percent. For workers turning 65 in 2030 and earning the average wage, benefits payable under present law will be only 36 percent of the worker's recent earnings without counting Medicare deductions, and are projected to fall to 32 percent of recent earnings with these deductions counted.

Second, and more fundamentally, the nation simply cannot afford to reduce the unique protection that Social Security provides. Social Security benefits are the principal source of financial support for two out of every three beneficiaries – and are vitally important to nearly all the rest. At the very least, benefit levels need to be maintained. Ideally, they should be improved, particularly in light of the increasingly uncertain future facing private pension plans. Traditional defined-benefit plans (many of them under-funded) now cover only about 20 percent of the private-sector workforce, and the 401(k) individual savings plans that are being substituted for traditional pension plans are vulnerable to cutbacks in employers' matching contributions, the vagaries of individual investment experience, and the option of being cashed out before retirement.

Any proposal to cut benefits, even "modestly," thus collides with two inescapable facts. The first is that no one can seriously argue that benefits are now too high – and, as noted, they are already being cut under current law. The second is the danger posed by the precipitous decline of private pensions and individual savings. Social Security, intended to function as one of the legs of a three-legged stool supporting economic security in old age, is now the only sturdy leg. It would be a terrible mistake to weaken it.

It is within this context that we must assess Social Security's long-term financing shortfall. I believe that an accurate assessment can lead to only one conclusion: changes are needed but radical changes are unwarranted. And the changes outlined here are anything but radical. They are vastly preferable to the drastic benefit cuts that would accompany privatization schemes or the drastic tax rate increases that would be required to cover the system's obligations in a strictly pay-as-you-go (no reserves) system. They are, in fact, not just necessary changes but desirable improvements that will strengthen the system now and for the long run – and without further cutting benefits.

It can be said of Social Security's future, as was once memorably said of the nation's, that the only thing we have to fear is fear itself. Social Security does not face bankruptcy. It is not going broke. The system faces only a long-term shortfall and requires only a few sensible changes such as those outlined here.

Robert M. Ball served as Commissioner of Social Security under Presidents Kennedy, Johnson, and Nixon, and thereafter on many advisory councils as well as on the bipartisan commission that led to the 1983 amendments. Founder of the National Academy of Social Insurance, he died in January 2008. He drafted this article (a revision of previous versions) in December 2007; it has been updated to include the maximum taxable earnings base for 2009 and related data.

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