Social Security Brief
September 1998 • No. 2

NATIONAL ACADEMY OF SOCIAL INSURANCE

Sooner is Better in Social Security Reform

By Michael J. Boskin

Summary

Social Security is important. It has brought down poverty rates among the elderly, but at the same time is a large share of federal spending and taxes. Changes in Social Security will also affect Medicare, labor force participation, and savings. Reforming Social Security is an urgent priority. Today, we have the opportunity to adopt reforms that would promote economic growth, which will make it easier to support an aging society. The United States has advantages that our trading partners lack: we face a less dramatic demographic shift, and our economy is stronger. Making changes soon allows for a more gradual phase-in, and lets workers adjust their plans. It would also head off pressure for large future tax increases which would impede economic growth and exacerbate the problem of paying for Social Security and Medicare.

Social Security is a large and growing share of federal spending. It also is a large and growing share of federal taxes. Today (excluding interest on the debt) Social Security and Medicare spending account for 40 percent of the federal budget; payroll tax collections represent over a third of the federal tax burden. Including the employer contribution, the typical family in America pays as much or more in payroll taxes as in income taxes.

While there is a tendency to separate Social Security and Medicare, we must think of resolving the problems in these programs in a coordinated fashion, because of their combined impact on the elderly and their aggregate levels of spending and taxes.

Social Security and the Economic Status of the Elderly

Social Security has contributed significantly to one of the greatest achievements of our society: the tremendous decrease in poverty among the elderly. The poverty rate of the elderly has declined from almost three times that of the general population to about the same as the general population today. (Obviously, this varies among subgroups within the elderly population; the poverty rate of elderly widows is relatively high.) What would have happened to the poverty rate of the elderly had Social Security not been expanded substantially over the past three decades? My own view is that a sizeable part of this decline in poverty is attributable to Social Security. At the same time, we also need to recognize that Social Security has, in part, replaced continued earnings and private savings.

Consider, for example, labor force participation. In the last three decades, the labor force participation of men age 65 and over has gone from a little under 30 percent to 16 percent or so. There has also been a very sharp decline in labor force participation of men aged 55 to 64.[1] There are many causes of this decline, but multiple studies document that Social Security has contributed to this early retirement trend.[2]

This implies that Social Security reforms must be evaluated in part based on what they would do to labor market behavior and to private savings. These are important matters to the Social Security program itself and the overall health of the economy.

Michael Boskin is the Tully M. Friedman Professor of Economics and Hoover Institution Senior Fellow, Stanford University. This Brief is drawn from a paper presented at the Academy's 1998 conference. The book of conference proceedings, *Framing the Social Security Debate: Values, Politics and Economics*, is forthcoming and will be distributed through the Brookings Institution Press, 202-797-6258.

The Future of Social Security

Next, let us consider the long-run projections for Social Security and Medicare. Medicare's Hospital Insurance Trust Fund, which is financed through the payroll tax, is currently taking in less in payroll taxes than it pays out in benefits. The 1997 Balanced Budget Act extended the exhaustion date of the trust fund's reserves a few years, but still leaves a large long-run actuarial imbalance.

Social Security also faces future deficits. Some time between 2010 and 2020, spending will start to exceed current tax revenues. Shortly thereafter, the Treasury has to start redeeming the bonds held in the Trust Fund in order to provide the cash to pay benefits. To redeem the bonds, the government will have to raise taxes, cut benefits, or issue new debt.

Thereafter, there is a large and growing deficit in cash terms. For the remainder of the 75-year projection period, three-quarters of the benefits could be paid by projected taxes. Some people look at these figures and conclude this is a minor problem — that a tax increase today on the employer and employee combined of 2.2 percentage points would take care of this problem for the next 75 years (almost triple that for the period thereafter). But placed in perspective, that is a substantially larger amount than the Reagan defense build-up, which was only temporary, lasting a few years. Worse yet, waiting until the cash deficits start to occur implies large benefit reductions or payroll tax increases of roughly 50 percent — to a level that would severely retard employment and economic growth.

Demography

Three demographic factors affect Social Security's long-term future: life expectancy, fertility, and the population bulge due to the baby boom.

Among Americans born at the turn of the century, about 40 percent could expect to reach age 65. For those born in 1990, that number was 80 percent, and almost a third could expect to reach age 85.[3] Many people talk about the gain in life expectancy in pessimistic terms, as a cost. And, certainly, it will put many strains and burdens on our society. However, anybody who thinks these gains in life expectancy are a bad thing because of the costs is missing the forest for the trees.

The changing demography will affect everything about our economy and society, not just our budget, Social Security and labor market activity — but where people live, how they choose to communicate, the savings and private insurance vehicles they are going to need to deal with various contingencies, and more.

Lately, we have enjoyed a remarkably benign demography. The ratio of the elderly to the working-age population has been essentially flat for many years and will be for another 10 years or so before it starts to rise due to the retirement of the baby boomers, after which it will increase by about 50 percent.

International Comparisons

Despite our large projected deficit in Social Security and Medicare, our major competitors will have even greater fiscal burdens associated with their demographic transitions. In all the G-7 countries, the old age dependency ratios are going up substantially. In the United States, we are going from roughly 1 person of retirement age for every 3.25 workers to 1 for every 2. Germany is moving toward 1 person of retirement age per worker.[4]

The United States has had a much lower tax burden than Western Europe. Compared to Western European nations, America has had much more rapid growth in the labor force, smaller growth in unemployment, and a huge number of private sector jobs created. Surely part of the explanation for the superior performance of the American economy is the substantially smaller role of the government — in taxes, spending, regulation, mandates, and industrial policy.

Reforming Social Security sooner rather than later, to prevent the pressure for large future tax increases which would crush the economy and exacerbate the funding problem, is an urgent priority.

The Political Economy of Reform

It is often said that, when people start receiving Social Security benefits, their own narrow self-interest will make it harder to adjust the system because they will resist changes that reduce their benefits. However, if people treat the taxes they have already paid during their life as sunk costs, and then ask how much they will receive in benefits if the current system is maintained, compared to the additional taxes they will pay (including tax increases to fund the actuarial deficit), narrow self-interest in favor of maintaining the status quo may kick in as early as the mid-forties. Thus, the way these demographic pressures may work through the voting process requires the nation to get on with Social Security reform soon, far sooner than hypothetical "trust fund exhaustion dates."

Reforms

Waiting until baby boomers begin to retire would be a bad time to undertake Social Security reform. It would be much better to build a consensus and make reforms soon, so workers will have an opportunity to plan with some assurance about the Social Security system they will have when they retire.

Even if Social Security did not have long-term actuarial deficits, it would be important to make changes such as more accurate cost-of-living adjustments, increases in retirement ages, and changes in the benefit and tax structure. We should also consider more fundamental changes that would give people the opportunity to invest some of their payroll taxes privately.[5] I believe some such set of reforms would be desirable to prevent a drain on saving and growth in the future, as well as to improve the efficiency, fairness and financial soundness of the system.

It would be much better to build a consensus and make reforms soon, so workers will have an opportunity to plan.

The transition from today's Social Security system to a reformed system is very important. Nobody is suggesting that the benefits of people who have already retired or will retire soon be radically altered. For younger people, whatever reforms are made should be gradually phased in.

The unfunded liability of Social Security is about $10 trillion in round numbers.[6] Some analysts have suggested that this liability is already incorporated into private behavior, and that issuing $10 trillion in recognition bonds, or raising taxes a like amount in present value, would have no impact on the economy. My view is that we cannot be sure what impact explicitly recognizing this liability (through issuing bonds or raising taxes) would have on the economy, but that it would not be wise to assume this would be a non-event; it might well severely retard the economy.

The Importance of Economic Growth

Finally, economic growth is a large and under-appreciated part of dealing with these issues. Economic growth is the single most important factor in thinking about intergenerational equity. If people a generation or two from now will be much richer than we are today, that would be a very different environment in which to be worried about the intergenerational transfers in Social Security than if they are going to be only slightly richer. Economic growth and reform of Social Security and Medicare are closely interrelated, with each affecting the other in important ways. A significantly higher growth rate would make many things more affordable, including future costs of these entitlements. But the ability of the economy to generate strong growth is likely to be severely impinged without sensible Social Security and Medicare reform. Economic policy must seek to remove barriers to growth. The types of Social Security reforms mentioned above are a major part of that agenda. ■

Endnotes

1. OECD, *Labour Force Statistics*, 1967, 1996.
2. See M. Hurd and M. Boskin, "The Effect of Social Security on Retirement," *Quarterly Journal of Economics*, Vol. 99, No. 4 (November 1984), pp. 767-790.
3. National Center for Health Statistics, *1990 Life Tables*.
4. OECD, *Ageing Populations*, 1988.
5. See M. Boskin, *Too Many Promises: The Uncertain Future of Social Security*, Dow-Jones-Irwin, 1986; M. Boskin, et al., "Social Security: A Financial Appraisal Within and Across Generations," *National Tax Journal*, Vol. XL, No. 1, (March 1987), pp. 19-34; and M. Boskin, J. Shoven, and L. Kotlikoff, "Personal Security Accounts: An Alternative Social Security Reform Proposal," in *Social Security and Private Pensions*, S. Wachter, ed., (Lexington, MA: Lexington Books) 1988.
6. There are two concepts of unfunded liability: the so-called "closed-group" concept, which does not include new entrants in the distant future, the $10 trillion figure; and the "open-group" concept, which would be much smaller, approximately $3 trillion, which does include new entrants in the distant future, but as can be seen from the difference, on an extremely adverse actuarial basis as implied by current law.

NATIONAL ACADEMY OF SOCIAL INSURANCE

This Brief is the second in a new series on Social Security and Medicare. If you would like to be on the mailing list to receive future briefs, fax your name and address to 202-452-8111, Attention: Briefs. Please indicate your interest in receiving briefs on Social Security, Medicare or both.

The full text of Academy Briefs, and ordering information for reports, are available on our website, www.nasi.org, or by calling 202-452-8097.

Financial support for the Conference and Social Security Briefs is provided by the AARP Andrus Foundation, the Alfred P. Sloan Foundation, TIAA-CREF and The Actuarial Foundation.

Publications on Social Security and Medicare

Medicare: Preparing for the Challenges of the 21st Century, 1998

Structuring Medicare Choices, 1998

From a Generation Behind to a Generation Ahead: Transforming Traditional Medicare, 1998

Disability: Challenges for Social Insurance, Health Care Financing & Labor Market Policy, 1997

Securing Medicare's Future: What are the issues? 1997

Balancing Security and Opportunity: The Challenge of Disability Income Policy, 1996

The Environment of Disability Income Policy: Programs, People, History and Context, 1996

Forthcoming

Evaluating Issues in Privatizing Social Security

Framing the Social Security Debate: Values, Politics and Economics

NATIONAL
ACADEMY
OF•SOCIAL
INSURANCE

1776 Massachusetts Avenue, NW
Suite 615
Washington, DC 20036-1904
202/452-8097
202/452-8111 Fax
nasi@nasi.org
www.nasi.org

BUG