Published by

AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

Great Barrington, Massachusetts 01230

RESEARCH REPORTS

Vol. LXV No. 3 February 9, 1998

"Saving Social Security"

The President's call to save Social Security will only be served if the misconceptions regarding its functioning can be cast away so that the genuine issues can be addressed.

In his State of the Union speech on January 27, President Clinton asserted that the Federal Budget will be balanced this year or next and that "we will have a sizable surplus in the years immediately afterward." He then asked, "What should we do with this projected surplus?" He responded to his rhetorical question with "I have a simple four-word answer: save Social Security first…I propose that we reserve 100 percent of the surplus — that's every penny of any surplus — until we have taken all the measures necessary to strengthen the Social Security system for the 21st century." He did not go into detail about what these measures might be, instead proposing that possible solutions to the program's financing problems should be discussed in a series of forums to be held around the country this year.

There is a wide range of options for reforming Social Security, some of which we have discussed in previous *Research Reports*. Generally, Democrats favor preserving the current system, while Republicans support giving individuals more freedom and responsibility for funding their retirement. It remains to be seen what changes will eventually be made. In the meantime, the President's proposal to "reserve 100 percent" of any budget surplus until reforms are enacted deserves a closer look.

The Wrong Way to Look at the Problem

The common perception is that the "trust fund" into which the portion of payroll taxes designated for "Old Age, Survivors and Disability Insurance" (OASDI) and from which benefits are paid will prove inadequate some time in the next century.

As shown in the Chart 1, the amounts paid into the fund have exceeded benefits paid out since 1985. This excess was about $83 billion during the last year and the fund now totals more than $600 billion. The trust fund is expected to reach a peak of nearly $3 trillion before the benefits due retirees begin to exceed the payroll taxes paid in and the interest credited by the Treasury on the fund's balance. This is projected to occur around the year 2019. During the following decade, however, the large numbers of persons born during the 1950s and early 60s will reach retirement age, and the rapid increase in projected benefits with stagnant projected OASDI tax receipts will completely deplete the trust fund.

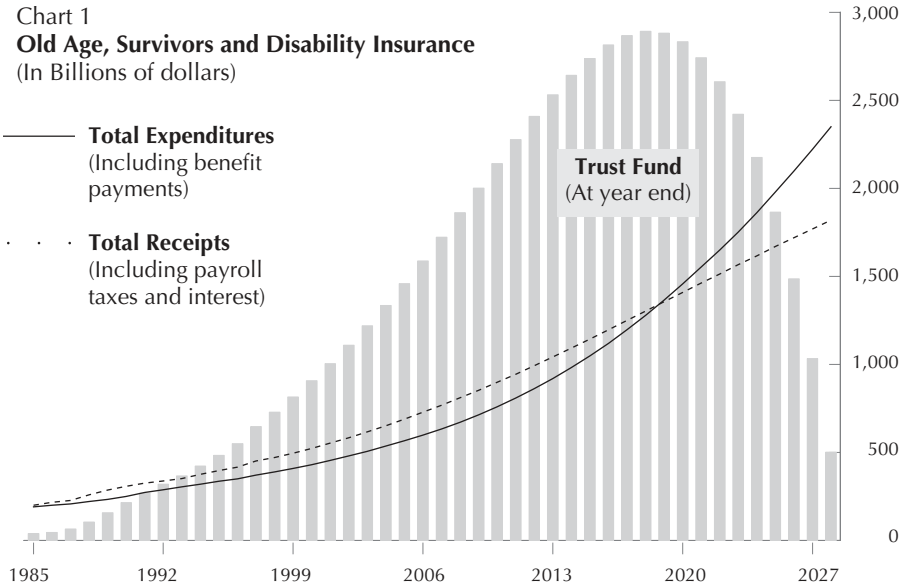
It may be noted that the timing of this is highly dependent on projections and estimates of future economic growth, prices, interest rates and wage levels, as well as projections of the future trends of labor force participation, births, deaths and immigration. The data shown in the chart are the most widely discussed and used. They are based on so-called "intermediate assumptions" of the actuaries of the Social Security Administration. If economic growth is slower, price inflation larger, or demographic trends less favorable than these assumptions, the "day of reckoning will" come sooner.

On the other hand, if price inflation remains low and sustained strong economic growth results in a larger and/or better paid labor force during upcoming decades, the trust fund will remain "solvent" (i.e., maintain a positive balance) throughout the 75 years covered by the actuaries' projections. In other words, faster economic growth with low price inflation could "save" Social Security.

However, the trust fund is not an indicator of the health or soundness of the Social Security system.

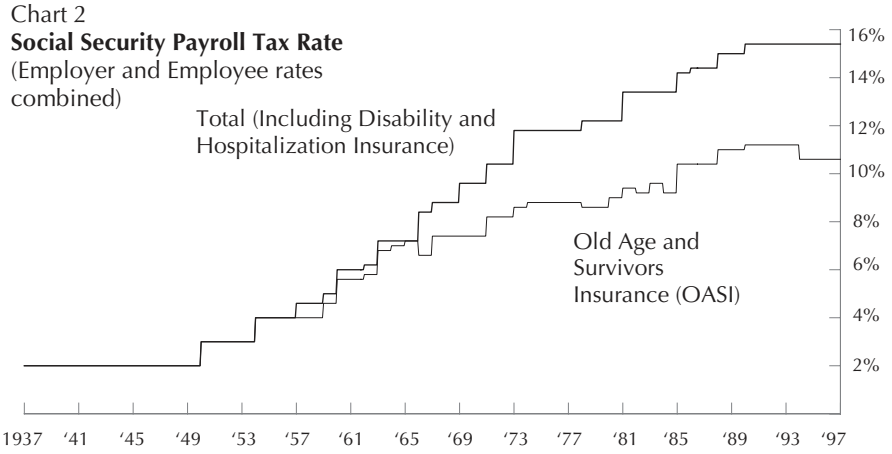
A Bookkeeping Device

As we have often observed, the trust fund is little more than a bookkeeping device. By law, surplus payroll taxes must be "invested" in special nonmarketable Treasury bonds. The issuance of these bonds is not included when calculating the Federal budget deficit or surplus, which is a measure of the net transactions of the



Note: Data after 1997 are projections based on intermediate assumptions of economic and demographic trends.
Source: *Office of the Chief Actuary, Social Security Administration.*

Chart 2
Social Security Payroll Tax Rate
(Employer and Employee rates combined)



Federal government with the public.

Social Security is a "pay as you go" plan. Benefits are overwhelmingly paid out of current tax receipts. In 1997, for example, the system paid out $369.9 billion in benefits, which was about 90 percent of the taxes received, $409.1 billion. The difference, $39.2 billion, plus $43.6 billion of interest credited to the fund, accounted for the $82.8 billion increase in the trust fund balance during the year. But it should be stressed that the latter amount offsets deficits in all the other functions of the Federal Government in all commonly reported discussions of the Federal budget deficit or surplus. If the Social Security trust fund was separate from the Federal Government, and its surpluses were invested in genuine assets, Federal budget deficits during the 1980s and 1990s, and the amount of Treasury debt sold to the public, would have been much larger, and the Federal budget would remain deeply in the red.

This is a relatively recent phenomenon. Historically, the trust fund has been little more than a working balance. When it began to "run low" it served as a reminder to Congress to raise the payroll tax, which it has done many times (see Chart 2). The last time this happened was in the early 1980s, when Congress adopted the recommendations of the Greenspan Commission. At that time, tax increases were scheduled by law. Congress had previously revised the way in which beneficiaries' initial benefits (Primary Insurance Amounts) are calculated to prevent "overindexing," which had greatly boosted benefit levels during the 1970s. These changes amounted to the first curtailment of benefits in the history of the system.

As it happened, these legislative "fixes" proved to be more than adequate to maintain Social Security on a pay as you go basis. The projections used at the time were based on the experience of low economic growth, high unemployment and soaring prices of the 1970s and early 1980s. With the rebound of the economy after the 1981-82 recession, the growth of employment and the abatement of price inflation, payroll taxes poured into the Treasury and total benefit payments did not increase as much as expected. The politicians did not mind this at all, as the excess of payroll tax receipts over benefits paid out served to mitigate the very large deficits in the rest of the Federal Government.

You Mean They've Spent the Trust Fund?

Yes. Although sound bites of a "man in the street" expressing outrage that "his" Social Security money has been spent are often presented as an indication of the increasing sophistication of the general public, it could hardly be otherwise. Given the pay as you go design of the system, and the mandate to invest in Treasury securities, most of Joe Sixpack's Social Security taxes, and everyone else's, are used to pay current retirees. Anything left over is lent to the Treasury. Does the Treasury, or anyone else, not spend borrowed money?

Under the current system, the politicians will be forced to increase the payroll tax rate, look for other means of paying benefits, reduce the benefits to be paid, or some combination of these before the trust fund balance decreases to zero in the year 2029 (under the SSA actuaries' intermediate assumptions). However, the "crunch" will come long before that. It will, in fact, be a gradual "squeeze." As the annual increases in the trust fund diminish and eventually become withdrawals, less and less of the payroll tax will be available to pay for other programs and eventually the Treasury will have to use non-payroll tax revenues to redeem the bonds in the trust fund or, more likely, borrow more from the public.

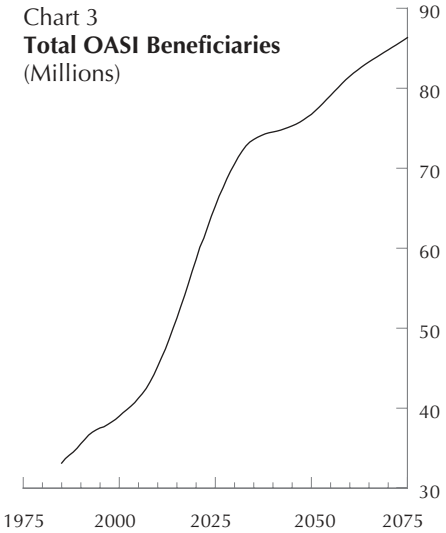
The President's Plan

What, then, does the President's proposal to "reserve 100 percent of...any surplus...until we have taken all the measures necessary to strengthen the Social Security system for the 21st century" imply? Not much.

First, the President's sincerity in his determination to "set aside" surpluses may be questioned, given the various new spending proposals in his speech. Nevertheless, suppose the Government runs a $20 billion surplus this year. Congress could earmark this $20 billion to go directly into the Social Security trust fund. Under current law, the $20 billion would have to be invested, along with the excess Social Security taxes collected this year, in those special Treasury bonds. This would leave the Treasury with the extra $20 billion. What would Treasury do with it? There are only two choices. The money could be used to pay for general Government spending unrelated to Social Security. But if the budget were already balanced this would not be necessary. The only other option would be to use the $20 billion to reduce the national debt.

Thus, using future budget surpluses to save Social Security boils down to using the surplus to reduce the national debt. From the standpoint of "saving Social Security," the impact of this juggling of Government books is nil. The trust fund would be bigger on paper (it would increase by another $20 billion in our example), but it would still be backed by nothing more than the Government's promise to find the money 20 or 30 years

Chart 3
Total OASI Beneficiaries
(Millions)



Note: Data after 1997 are projections based on intermediate assumptions of economic and demographic trends.
Source: *Office of the Chief Actuary, Social Security Administration.*

CONSUMER PRICE CHANGES IN 1997

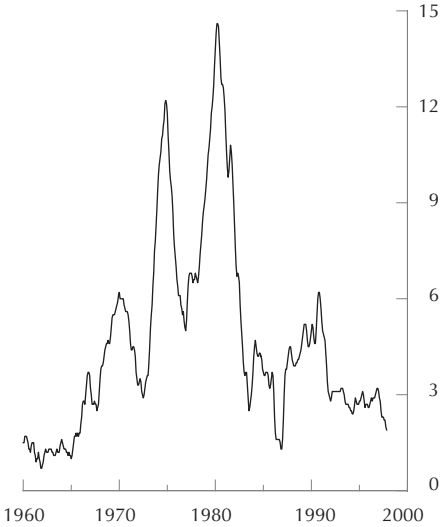
The Consumer Price Index increased 1.7 percent last year, the smallest rise in over a decade. This increase in the price of a representative "market basket" of goods and services masks large differences in the price changes for individual items.

The rate of price inflation, as measured by the Consumer Price Index (CPI), was 1.7 percent last year. For the past 5 years, the CPI has increased less than 3 percent a year. As can be seen in the accompanying chart, this is the best record since the 1960s.

The change in the CPI masks wide variation in the rates of price change for individual goods and and services.

A breakdown of the CPI into selected goods and services, as shown in the table below, reveals where price pressures were greatest in 1997. Consumers who spent more than the national average on items for which price increases were relatively larger suffered a larger increase in their cost of living than that implied by the 1.7 percent increase in the CPI. Those who purchased more of the items whose prices increased less or decreased experienced a smaller increase in their cost of living. Readers may judge for themselves how accurately the increase in the CPI reflects their own experience in the marketplace last year.

Annual Percentage Change in the Consumer Price Index



Percent Changes in Selected Consumer Price Indexes
December 1996 – December 1997

Expenditure Category	*Percent Change*
All Items	1.7
Food and beverages (17% of expenditures)	1.6
Food	1.5
Food at home	1.0
Cereals and bakery products	1.5
White bread	1.5
Meats	–0.7
Beef and veal	–0.7
Pork	–1.5
Poultry	–1.6
Fish and seafood	1.2
Eggs	–7.2
Dairy products	–0.5
Fresh whole milk	–1.7
Cheese	–1.2
Ice cream and related products	0.9
Fresh fruits and vegetables	2.8
Apples	–0.1
Bananas	–3.8
Potatoes	9.2
Lettuce	18.4
Fruit juice and frozen fruit	0.3
Frozen vegetables	2.9
Sweets, including candy	2.7
Nonalcoholic beverages	4.9
Coffee	16.9
Canned and packaged soup	2.3
Frozen prepared food	–0.9
Snacks	2.6
Food away from home	2.6
Lunch	2.6
Dinner	2.6
Alcoholic Beverages	2.2
Beer and ale	–0.5
Wine	2.4
Distilled spirits	2.3
Housing (41% of expenditures)	2.4
Shelter	3.4
Renters' costs	3.9
Homeowners' costs	3.1
Maintenance and repairs	2.9
Fuel oil	–11.7
Electricity	–1.3
Utility (piped) gas	3.3
Telephone services	0.2
Local charges	1.0
Interstate toll calls	–4.3
Water and sewerage maintenance	4.0
Cable television	6.9
Refuse collection	2.0
Household furnishings and operation	0.1
Housefurnishings	–1.4
Bedroom furniture	0.8
Sofas	–1.1
Living room chairs and tables	–2.6
Televisions	–4.3
Video products other than televisions	–8.1
Audio products	–2.0
Refrigerators and home freezers	–3.4
Laundry equipment	0.2
Stoves, ovens, dishwashers, and air conditioners	–2.3
Information processing equipment	–12.1
Clocks, lamps, and decor items	3.4
Tableware, serving pieces, and nonelectric kitchenware	4.9
Lawn equip., power tools, hardware	–1.1
Housekeeping supplies	1.4
Housekeeping services	2.4
Apparel and upkeep (6% of expenditures)	1.0
Men's apparel	2.5
Suits, coats, and jackets	1.9
Shirts	0.8
Dungarees, jeans, and trousers	–0.2
Boys' apparel	3.3
Women's apparel	0.6
Coats and jackets	0.5
Dresses	–5.0
Separates and sportswear	–0.3
Suits	11.4
Girls' apparel	–1.1
Infants' and toddlers' apparel	–0.9
Watches	–0.3
Jewelry	–1.2
Footwear	1.8
Laundry, dry cleaning, and other apparel services	1.4
Transportation (17% of expenditures)	–1.4
New cars	–1.0
Subcompact	–1.7
Compact	–1.0
Intermediate	–0.7
Full–size	–2.2
Luxury	–0.4
New trucks	–0.1
New motorcycles	0.8
Used cars	–4.9
Motor fuel	–6.2
Automobile maintenance and repair	2.6
Tires	–2.8
Automobile insurance	2.4
Automobile finance charges	–3.1
Automobile fees	4.9
Public transportation	–2.9
Airline fares	–4.8
Public transportation within city	1.1
Medical care (7% of expenditures)	2.8
Medical care commodities	2.3
Prescription drugs	2.5
Over-the-counter drugs	1.1
Medical care services	2.9
Physicians' services	2.7
Dental services	4.0
Eye care	1.9
Hospital and related services	3.2
Entertainment (4% of expenditures)	1.4
Entertainment commodities	–0.1
Newspapers	0.5
Magazines, periodicals, and books	1.7
Sport vehicles, including bicycles	–0.5
Other sporting goods	–0.3
Toys, hobbies, and music equipment	–1.6
Photographic supplies and equipment	0.8
Pet supplies and expense	–0.4
Entertainment services	2.5
Club memberships	–0.4
Admissions	3.4
Fees for lessons or instructions	5.2
Other goods and services (7% of expenditures)	5.2
Tobacco and smoking products	7.2
Personal care	2.3
Cosmetics and related products	2.2
Beauty parlor services for females	3.0
Haircut and other barber shop services for males	2.8
Personal and educational expenses	5.2
School books and supplies	5.1
College tuition	4.6
Elementary and high school tuition	7.2
Day care and nursery school	4.6
Legal service fees	5.1
Personal financial services	6.0
Funeral expenses	5.1

from now to pay off the special bonds held by the fund. The taxpayers of, say, 2015 would still have to provide *all* of the revenue needed to finance Social Security benefits and other Government programs in 2015.

Moreover, the net effect on the Government's overall finances should it "set aside" any budget surplus would be the same if it simply used the surplus to reduce the national debt. Either way, the national debt would be reduced by the same amount. Either way, the Government's obligations to future Social Security beneficiaries will be unchanged — and unfunded.

The real problem is not the eventual depletion in the trust fund shown in Chart 1, but *the marked increase in benefit payments* evident in that chart. This mainly reflects a substantial increase in the number of beneficiaries (from about 38 million at present to nearly 70 million in 2029, see Chart 3), not only because the baby boomers will reach retirement age, but also because retirees are living longer and longer than when the system was established.

Supporting the Elderly

The notion of retiring from productive life before one's productive abilities have been exhausted is a relatively recent one. Nevertheless, except for a very few very primitive societies who simply abandoned their unproductive members in the jungle or on ice floes, civilized societies provide for their elderly and infirm. Traditionally, this support has come from the descendants and relatives of the individuals concerned. In more advanced civilizations, especially those with well-developed financial systems that facilitated long-term saving (as opposed to simple hoarding), individuals became able to provide for their old age by setting aside something from their productive years. Finally, most industrial economies have some system of forcibly transferring income from current workers to the elderly. The Social Security system is our way of doing this.

One of the initial goals of the designers of the system — removing workers from the labor force — has long since faded in significance along with the memories of the very high unemployment of the 1930s. In fact, the high level of payroll taxes has become a barrier to employment at all age levels. But despite the longing of Libertarians and others who deplore government handouts of all kinds, the major goal of the system — ensuring that the elderly will have some assured means of support — remains. Low birth rates and high divorce rates mean that large and extended families have become a rarity. Some people are improvident or simply unlucky. We can expect that the government will remain in the business of transferring income from workers to the elderly.

The question is, how can we make such a system affordable?

Requisites for Reform

The widespread misconceptions held by the public, and even by politicians who should know better, are the major barriers to genuine reform of Social Security. From its onset, the Social Security system has appropriated the language of private finance. It is "insurance" without underwriting or genuine reserves. As we have discussed in some detail, the comfortingly titled "trust fund" in no way provides for future benefits, which will come from levies on future workers and other taxpayers, or from borrowing.

The elaborate system of recording individual "contributions" was from its beginning a means of getting the public to accept the fact that the government was taking money from some people and giving it to others. "Benefits" can vary widely in relation to past earnings and taxes paid, according to whether the earnings were above or below average (low income workers receive a much better "deal" — mitigated only by the fact that those with a history of high earning tend to live and collect benefits longer) and according to marital status and the dependents.

Social Security is, to repeat, an income transfer program. Unless this becomes more widely recognized, efforts at reform are unlikely to focus on the real issues: what level of support do we want to guarantee to the elderly via government transfers, what is to be the age and/or circumstances of those qualified for such support, and what is the best way of financing the payments. As we have discussed elsewhere (see our *Economic Education Bulletin* for November 1994, for example), we believe that future individual benefits should converge at some uniform level of minimum subsistance and that this would be best financed with a broad-based tax rather than simply from taxes on payrolls. Both of these reforms would mean scrapping the notion that Social Security benefits are a return on an individual's "contributions."

We can only hope that these issues will emerge in the discussions that President Clinton has called for. ❑

Fools and Knaves

If President Clinton's call for public forums to discuss the future of Social Security comes to pass, it is likely that the debate will be dominated by those who do not understand the system or who deliberately misrepresent it. These may be identified in two ways:

First, anyone who mentions the OASI trust fund or the fact that it holds Treasury securities as a reason to believe that future benefit payments are assured is wrong; in fact, benefits in a given year must come from that year's taxes or borrowing.

Second, anyone who asserts that benefits have been "earned" is also wrong. Congress levies the taxes and sets the conditions for receiving benefits, and any link between the two processes is sheer artifice.

The irony of this is that it is likely that the Nation could afford to provide more to those in genuine need (which presumably remains the motivation of those who deliberately misrepresent the situation), if that were made the goal of the program while dropping the trappings of insurance, savings, and investment that have misled so many for so long.

PRICE OF GOLD

	1996	*1997*	*—— 1998 ——*	
	Feb. 8	*Feb. 6*	*Jan. 29*	*Feb. 5*
Final fixing in London	$407.90	$342.80	$302.50	$299.15

Research Reports (ISSN 0034–5407) (USPS 311–190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: $16 per quarter or $59 per year. POSTMASTER: Send address changes to ***Research Reports***, American Institute for Economic Research, Great Barrington, Massachusetts 01230.