Why Social Security Needs Fundamental Reform

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Public discussion about the financial health of Social Security usually focuses on the long-run solvency of the program, typically expressed in terms of the year the Social Security actuaries estimate the trust fund will be exhausted. However, the focus on trust fund balances misses the real problem. Social Security is a federal entitlement paying defined benefits funded on a pay-as-you-go basis. As such its financial status is highly vulnerable to demographic swings that affect the ratio of beneficiaries to taxpayers. Unfavorable demographics are now on the horizon as the baby-boomers approach retirement. But the trust fund is not a fund in the usual sense. It has no mechanism for pre-funding benefits and holds no assets that can be used to cover deficits in the Social Security account. The coming financial crisis has spurred critical evaluation of Social Security and consideration of fundamental reform. A common element of several reform proposals is to convert Social Security from a pay-as-you-go program to a pension system that is based partly or mainly on individual accounts funded by defined contributions. The goal would be to establish a means for pre-funding a significant portion of future benefits and at the same time give individuals ownership of their own pension assets and consequently more control of their own consumption and saving patterns, thereby improving incentives to work and to save.

In the United States, as in many other countries, changing demographics are expected to create long-term strains on the federal budget, forcing us to reexamine Social Security—the nation’s primary public program providing retirement and disability benefits.1 Over the past decade, many analysts and two prominent governmental commissions have recommended major changes in Social Security that go beyond simply finding a solution for the program’s future funding problems.2 A common element of the proposed reforms is to convert

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1 Social Security refers to the combined Old-Age and Survivors Insurance and Disability Insurance programs (collectively known as “OASDI”).

2 The 1994–1996 Advisory Council on Social Security, chaired by Edward M. Gramlich, could not agree on a single plan for reforming Social Security and finally produced three plans (each supported by different Council members), two of which included a component of individual accounts. The three plans are: (I) Maintenance of
Social Security from a federal entitlement program paying defined benefits to a pension system that is based, at least in part, on individual accounts funded by defined contributions. Such a change would provide a mechanism for pre-funding some portion of future benefits. Importantly, it would give individuals ownership of a significant component of their own pension assets, offering greater flexibility and more options. It could improve incentives to work and to save. It would also mark a significant philosophical change, providing individuals with more control but also more responsibility for their own consumption and saving patterns. It is bound to be controversial. In this Article, I review the long-term budgetary and economic issues raised by the current program and discuss options for change.

I. DEMOGRAPHICS AND THE BUDGET PROBLEM

As it is now structured, Social Security is funded like most government programs: the taxes of current workers pay the benefits of current recipients. However, Social Security is committed to paying large benefits to members of a major population group—the elderly and disabled—without regard to financial need. When such a program is funded on a pay-as-you-go basis its financial status is highly vulnerable to swings in the birth rate, to changes in mortality rates, and to other variables that can cause major shifts in the ratio of beneficiaries to taxpayers.

Over the past twenty-five years, demographic factors were relatively benign as growth in the number of beneficiaries increased at about the same rate as growth in the number of covered workers. However, the demographic factors

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driving Social Security’s financial status are expected to become increasingly unfavorable after 2010, when the number of beneficiaries will begin to mount rapidly while growth in the number of workers slows. The coming surge in beneficiaries is tied both to the retirement of the baby boomers—the huge cohort born between 1946 and 1964—and to increases in life expectancy. As the baby boomers exit the labor force, the remaining working age population will be increasingly drawn from the smaller generations born after the baby boom.

The 2003 annual report of the Social Security trustees projects that the number of workers per beneficiary will fall from the 2002 level of 3.3 to a level of 2.2 in 2030, with most of the change occurring after 2010. After 2030 the ratio is expected to continue to decline, but at a slower pace, dipping to 1.8 workers per beneficiary by 2080. Although all projections are inherently uncertain, the demographic outlook is likely to be on firmer ground for the next few decades because the size of the retired and working populations are reasonably well-established in the near term. As the population ages, the benefits scheduled under current law will consume an increasing share of the nation’s resources, as measured by the Gross Domestic Product (GDP). According to projections of the Congressional Budget Office (CBO), Social Security benefits made up 4.2 percent of GDP in 2000. That percentage is projected to be roughly stable through 2010 after which it will begin to rise, reaching 6.2 percent of GDP in 2030. Medicare benefits, as a percentage of GDP, are projected to continue to increase more rapidly than Social Security benefits. The combined cost of Social Security plus Medicare is expected to increase from about 6 percent

\[TR/TR03/IV.SRest.html#wp209325.\]

\[4\] Id. at 50.
\[5\] Id. at 16, 50.
\[6\] Id. at 50.
\[7\] See id. at 51–52 & tbl. IV.B2.
\[8\] Id. at tbl. IV.B2.
\[9\] The ratios of workers to beneficiaries are based on the “intermediate” assumptions of the Social Security actuaries. Id. at 6 & tbl. II.C1. The projected values based on the low cost and high cost assumptions are quite close to those based on the intermediate assumptions through 2030. Reflecting the increase in uncertainty with time about such things as life expectancy, fertility, and work participation, the projections based on low and high cost assumptions become more divergent after 2030. See id. at 50–53.
\[11\] Id.
\[12\] Id.
\[13\] See generally id.
of GDP in 2000 to approximately 11 percent in 2030. The demographic trends, therefore, point to a future of major financing problems under the existing program.

II. FINANCING SOCIAL SECURITY

In some respects Social Security has the appearance of a funded pension program operated independently from other programs. It is labeled an “off-budget” program in the federal accounts, pays benefits related to past earnings and collects “contributions” from workers and employers based on earnings in the form of a payroll tax, and its financial operations and status are recorded by a trust fund. In practice, however, Social Security is a federal transfer program that is an intrinsic part of a unified federal budget. Payroll tax receipts for Social Security are intermingled with income taxes and other sources of federal revenues.

14 See id. Medicare is an open-ended benefit since it is essentially fee-for-service with the government paying the fees. Despite efforts to control prices, the expansion of benefits provided to retirees continues to escalate program expenditures. See generally id. The addition of a prescription drug benefit, for example, would considerably increase the estimates shown.

15 The “off-budget” label given to Social Security outlays and revenues can be observed in all federal budget documents. See e.g., CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE, summary tbl. 1, tbl. 1-1 (Aug. 2001) [hereinafter BUDGET AND ECONOMIC OUTLOOK], available at ftp://ftp.cbo.gov/44xx/doc4493/08-26-Report.pdf (last visited Feb. 15, 2004). The “off- budget” status of Social Security, however, is only relevant in an accounting sense. For all practical purposes it is the unified budget that is used to calculate the government’s deficit as it is usually cited. See infra note 18.


17 See id. at 26.

18 The deficit, as usually reported, is the unified budget deficit that combines all federal outlays and receipts—whether labeled “on” or “off” budget. See generally BUDGET AND ECONOMIC OUTLOOK, supra note 15. The intermingling of payroll and income taxes arises from the fact that all checks are sent to the United States Treasury. See, e.g., United States Treasury, Daily Treasury Statement, tbl. IV (Feb. 11, 2004), available at http://fms.treas.gov/dts/04021100.pdf (last visited Feb. 15, 2004) (reporting “withheld income and employment taxes” without distinguishing between the two for a period of time); see generally CONGRESSIONAL BUDGET OFFICE, THE IMPACT OF TRUST FUND PROGRAMS ON FEDERAL BUDGET SURPLUSES AND DEFICITS: LONG RANGE POLICY BRIEF (Nov. 4, 2002) [hereinafter LONG RANGE POLICY BRIEF], available at
The existence of the Social Security trust fund has generated confusion about the financial operations of the program. In my view, the label “trust fund” supports an illusion that the tax contributions of workers are invested in tradable assets and held to pay their benefits at retirement. But in reality, the fund functions only as a complex accounting mechanism for tracking Social Security revenues and outlays, each year recording the difference between Social Security tax collections and payments to current beneficiaries. In most years, receipts have exceeded benefits, creating a “social security surplus.” The surpluses are credited as net additions to the trust fund. On paper, the reserves that accumulate in the trust fund are recorded as investments in special Treasury Bonds and collect interest that is also recorded as an addition to the fund. However, those so-called assets are simply a record of the accumulated sum of funds transferred from Social Security over the years to finance other government operations, the debt owed by one part of the government to another. They do not provide the government as a whole with additional resources. Because the trust fund does not hold assets that can be sold to pay current benefits, the federal government must acquire additional resources to make good on the commitment when Social Security taxes fall short of promised Social Security benefit payments. This can be done through a tax hike, through a

19 The significance of the trust fund has been a source of much controversy. See, e.g., Andrew G. Biggs, Perspectives on the President’s Commission to Strengthen Social Security, The Cato Project on Social Security Privatization SSP No. 27 (Aug. 22, 2002) [hereinafter Perspectives], at http://cato.org/pubs/ssp/ssp27.pdf (last visited Feb. 15, 2004). Biggs discusses the views of various writers, several of whom oppose the views on the trust fund espoused by the President’s Commission to Strengthen Social Security. Id. at 7–15.

20 See also SOCIAL SECURITY: A PRIMER, supra note 16, at 26–28 (discussing financing and the trust fund).

21 BUDGET AND ECONOMIC OUTLOOK, supra note 15, at tbl. F-4 (illustrating the historical record of the “on budget” and the Social Security deficits/surpluses and the total budget deficit/surplus).

22 Id.
reduction in non-Social Security expenditures, or by borrowing from the public. But government also has the option to reduce Social Security benefits: in the short run by postponing a cost of living increase, or in the long run by modifying the formula for determining benefits or increasing the age of retirement.\textsuperscript{23} A president and a congress in power today cannot guarantee that future benefits or tax rates will remain as stipulated in current law.

During the 1990s the Social Security accounts developed a sizeable surplus, partly due to a slowdown in the growth of new beneficiaries as the low-birth cohorts of the late 1920s and 1930s reached retirement age.\textsuperscript{24} In addition, the tax rate and the taxable maximum had risen substantially between 1980 and 1990.\textsuperscript{25} Low unemployment and rising wages also contributed. By fiscal year 2000, the Social Security surplus had grown to $152 billion, or 1.5 percent of GDP.\textsuperscript{26} The CBO projects it will continue to increase over the next decade, reaching more than $300 billion in 2013.\textsuperscript{27} However, the surpluses are expected to fade rapidly over the following decade as the impact of the retiring baby boomers on benefit outlays grows larger and larger.\textsuperscript{28} The Trustees’ Report estimates that Social Security benefit payments will exceed Social Security revenues by 2018, and the

\textsuperscript{23} Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65 (codified as amended in scattered sections of 42 U.S.C.). Spurred by an imminent financial shortfall, the 1983 Amendment to the Social Security Act made a number of unprecedented changes. On the revenue side the payroll tax rate was raised in the near term by moving forward the tax rate increases that had been scheduled for later years and coverage was extended to workers in nonprofit organizations and to federal employees. John A. Svahn & Mary Ross, \textit{Social Security Amendments of 1983: Legislative History and Summary of Provisions}, 46 \textit{Social Security Bulletin} 3–48 (July 1983). Near-term benefits were effectively reduced for current retirees by postponing the scheduled Cost of Living Adjustment (COLA) for six months. \textit{Id.} Future benefits were reduced by raising the age at which full retirement benefits could be collected from sixty-five years to sixty-seven years. \textit{Id.} The increase is phased in by two months a year starting with those attaining age sixty-two in 2000 and the full retirement age reaches sixty-seven for those attaining age sixty-two in 2022. \textit{Id.} Social Security benefits were effectively further reduced by subjecting a varying portion of benefits to the federal income tax, depending on other income. \textit{Id.}

\textsuperscript{24} \textit{See generally Budget and Economic Outlook}, tbl. F-4, \textit{supra} note 15; \textit{Trustees' Report}, \textit{supra} note 3 (showing changes in the number of beneficiaries).

\textsuperscript{25} \textit{Trustees' Report}, \textit{supra} note 3, at tbl. VI.A.1.

\textsuperscript{26} \textit{Budget and Economic Outlook}, \textit{supra} note 15, at tbls. F-4, F-5.


\textsuperscript{28} \textit{Trustees' Report}, \textit{supra} note 3, at 2; \textit{see also id.} at tbl. VI.F.10.
resulting deficit will grow rapidly thereafter.29

What happens when Social Security taxes fall short of Social Security benefit payments? Although the actuaries do not expect the trust fund to be exhausted until 2042,30 the date of practical fiscal significance is 2018—the year when Social Security benefit payments exceed Social Security payroll tax receipts, and the program becomes a current liability to the federal budget. At that time, the trust fund is projected to hold more than five trillion dollars in reserves.31 However, those reserves do not hold assets that can be sold to pay the bills. With or without the trust fund, the government must acquire additional resources from taxes, borrowing, and the like in order to fully cover expenditures on benefits. The amounts needed to cover currently scheduled benefits will be huge.32 The existence of the trust fund does not ease the cash flow problem.

III. THE VALUE OF THE TRUST FUND

The value of the trust fund has been the subject of much debate. The interim report of the President’s Commission to Strengthen Social Security, issued in August 2001,33 attracted considerable attention by noting: (1) that the trust fund does not pre-fund future benefits and (2) that while trust fund reserves are an asset to Social Security, they are an equal liability to the Treasury and therefore are not a net asset to the government, available to pay future benefits.34 Although similar comments about the trust fund have been made by the General Accounting Office (GAO), the CBO, and private economists and policy analysts, the Commission’s comments stirred up a storm, particularly from opponents of individual accounts.35

29 Id.
30 Id. at 3.
31 It is projected that the end of year assets in the trust fund will rise from $4.9 trillion in 2015 to $6.4 trillion in 2020 under the intermediate assumptions. TRUSTEES’ REPORT, supra note 3, at tbl. VI.F9.
32 For example, based on the Trustees’ estimates, increasingly large tax hikes would be required to cover annual OASDI benefit costs after 2018. See id. at 2. By 2035, payroll taxes would have to increase by 33 percent over the current law tax rate to close the expected shortfall. See id. at 67–69, tbl. IV.B10. Moreover, these estimates do not include the projected shortfall in the HI program which is expected to grow even more rapidly than that in OASDI. See generally id.
34 See id. at 17.
35 See SOCIAL SECURITY: A PRIMER, supra note 16, at 43. In this report, the Commission asserts the following:

The perspective of trust fund accounting provides, at best, only a partial view of
Opponents of individual accounts and analysts who support the pay-as-you-go system hold the view that the assets held in the trust fund are not worthless paper, but in fact have a real economic value that helps to finance the benefits of future retirees. The argument, in brief, as stated by Aaron, Munnell, Blinder and Orszag is that: “The accumulation of Trust Fund reserves raises national saving, reduces the public debt and thereby reduces the annual cost of paying interest on that debt, and promotes economic growth.”

Presumably such a favorable chain of events would make it easier to pay obligations in the future when Social Security payroll tax receipts are projected to fall short of benefit payments.

This argument, however, is based on assumptions about the behavior of policymakers and of the economy that other analysts view as unrealistic. The “reserves” in the trust fund are the excess Social Security taxes that were used to finance other federal programs. They can be viewed as increasing savings only if they contribute to reducing the total (unified budget) government deficit (or increase the total government surplus in the event of a non-Social Security surplus). However, as Kent Smetters has shown, the empirical evidence suggests that the accumulation of trust fund assets has encouraged larger deficits in the non-Social Security programs than otherwise would be the case, thereby

the challenges posed by the aging of the population. Whether a program receives earmarked revenues and is accounted for through a government trust fund or relies on annual appropriations does not alter the fact that whatever resources the federal government is required to spend it must acquire through taxes, borrowing, sales of assets, or some combination of those actions. Ultimately, the government’s ability to meet future commitments—whether Social Security benefits or some other payments—depends on the total financial resources of the economy and the willingness of citizens to fund those programs, not on the balances attributed to the trust funds.

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...[S]ome approaches for making the Social Security trust funds solvent would, by themselves, do nothing to reduce the program’s obligations or increase the nation’s economic capacity to meet those obligations. For example, the Congress could pass a law transferring enough funds from the federal government’s general fund to the Social Security trust funds to ensure that those funds always showed a positive balance. That would fix the solvency problem on paper. But such accounting devices—moving money from one part of the budget to another—would not directly affect either the size of the economy or the government’s obligations to the elderly.


37 See Perspectives, supra note 19, at 9–15.
increasing the level of debt, instead of increasing savings. Long-term observers of Washington politics probably will find such a result to be quite credible. Surpluses have seldom gone unclaimed for long.

IV. CAN FUTURE BENEFITS BE PRE-FUNDED UNDER PAY-AS-YOU-GO?

One financing problem of a pay-as-you-go system is that it is particularly vulnerable to demography and it is difficult to pre-fund benefits—that is, to save now to pay for future benefits. Defenders of the current system have proposed two solutions: the “lock-box” and government purchase of private equities for the trust funds.

The rare emergence of a unified budget surplus in the late 1990s and projections of increasing surpluses for at least another decade gave rise to a number of proposals for saving the current surplus to help fund the benefits of future retirees. The “lock-box” simply means that any unified-budget surplus that materialized would be used to reduce the publicly held debt. Debt reduction might ease Social Security’s future funding gap in two ways. First, reducing the debt lowers the annual interest charges the government pays on that debt and presumably that would free up budgetary resources to be used for other purposes. However, there is no way to guarantee that any budget savings would in fact be

38 See generally Kent Smetters, IS THE SOCIAL SECURITY TRUST FUND WORTH ANYTHING? (Nat’l Bureau of Econ Research, Working Paper No. 9845, 2003), available at http://irm.wharton.upenn.edu/WP-Security-Smetters.pdf. Smetters’ regression analysis estimates the effect of increases in the off-budget (Social Security) surplus on the on-budget (non-Social Security) surplus over the period 1949–2002 and includes controls for changes in GDP, wages and salaries and trend factors. Id. at 18–19. His results indicate that a one dollar increase in the Social Security surplus is associated with a $2.76 decrease in the non-Social Security surplus and therefore a $1.76 decrease in the unified budget surplus, other things being the same. Id. at 19. These results are statistically significant at the 2% level and are upheld using alternative estimating methodologies. Id. at 20.


41 See Press Release, supra note 40.

42 See id.
used to pay Social Security benefits. Future Congresses and Presidents may have other priorities. The second way is even more indirect. It relies on the presumption that debt reduction would lower interest rates economy-wide, boosting national savings and investment and ultimately increasing the size of the economy and the incomes of future workers and tax payers. However, it is debatable whether this favorable chain of events would occur with the strength needed to produce a significant increase in future national income.\footnote{Even assuming that a total budget surplus is realized over the next decade and that it is not used for any other purpose than paying down the debt, the extent to which national income would rise is uncertain. At issue is the response of private savers to the increase in government saving from running large surpluses. If private saving fully offset government saving, then there would be no net saving increase and no expected effect on investment and economic growth. See \textit{Social Security: A Primer, supra} note 16, at 60–61. However, this is a difficult matter to resolve. Some estimate that economic growth would be positively affected by saving the surplus, but the effect would be small. See generally Rudolph G. Penner et al., \textit{Urban Institute, Saving the Surplus to Save Social Security: What Does It Mean?} (1999), http://www.urban.org/UploadedPDF/BRIEF7.pdf. Based on a projection that a total budget surplus would be realized every year from 2000–2021 and that all of it would be saved, it is estimated that the growth of consumption per capita would be 0.1 higher per year over the 1999–2023 period. \textit{Id.} at 4. By 2023, the level of per capita consumption would be two percent higher. \textit{Id.} at 5.}

In the late 1990s, the prospect of a future of total budget surpluses also spurred proposals to pre-fund future obligations by using the surplus to purchase private securities for the trust funds.\footnote{See \textit{Aaron & Reischauer, supra} note 40, at 77–85; Martin Feldstein & Jeffrey B. Liebman, \textit{Social Security} 77–85 (Nat’l Bureau of Econ Research, Working Paper No. W8451, 2001) (discussing the shift in composition of Social Security trust funds from government bonds to private securities), \textit{available at} http://www.ksg.harvard.edu/jeffreyliebman/handbook.testmfljul31a.pdf; see generally \textit{Social Security: A Primer, supra} note 16.} Advocates of investing in private securities rather than government bonds claim that investing the surplus in private assets would likely yield a higher return than Treasury Bills and would more securely earmark the proceeds for Social Security.\footnote{Feldstein & Liebman, \textit{supra} note 44, at 77–85.} However, government investment in private companies would have serious drawbacks.\footnote{\textit{Id.}} The size and composition of such government investments could be destabilizing to markets.\footnote{\textit{Id.}} The possibility of government interference in the operation of private companies in which it has a stake is a concern.\footnote{\textit{Id.}} And, when the mere meeting of an economic group, such as the World Trade Organization, attracts legions of protestors, such public
investment in private markets could be a source of ongoing political conflict.\textsuperscript{49}

Saving the surplus appears to have faded as a realistic option with the advent of budget deficits in 2002 and projections of deficits for the next seven or eight years. However, given the inherent uncertainty of forecasts, a surplus might emerge sooner than currently expected. But it would hardly be prudent to count on such a surplus as a major source of funds for Social Security financing purposes. Of course, as long as government remains the controlling “owner” of the surplus, proposals that rely on using the surplus to fund future Social Security liabilities also run the risk that the surplus, or the future income that it might generate, would be diverted to other uses. The only way to reliably pre-fund retirement benefits is through a system of individual accounts in which investments are privately held and owned by the worker. This would require a more fundamental change in the system.

V. FUNDAMENTAL CHANGE

Growing recognition that the financial situation of our pay-as-you-go system is unsustainable has spurred consideration of Social Security reform. But the extent to which fundamental change should be undertaken more importantly depends on whether the program as currently designed meets our goals and is worth sustaining.

Social Security was developed almost seventy years ago in the depths of the Great Depression.\textsuperscript{50} Originally, the primary goal of Social Security, as stated in various government reports and presidential speeches, was to alleviate poverty among the elderly. In signing the Social Security Act on August 14, 1935, President Roosevelt, in a frequently quoted statement, said:

“We can never insure one hundred percent of the population against one hundred percent of the hazards and vicissitudes of life, but we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age.”\textsuperscript{51}

Social Security benefits, however, were never targeted on the poor. The


\textsuperscript{50} C. EUGENE STEUERLE & JON M. BAKIJA, RETOOLING SOCIAL SECURITY FOR THE 21ST CENTURY: RIGHT AND WRONG APPROACHES TO REFORM 15 (1994) (providing a history of the Social Security program).

political wisdom, as expressed by Wilbur J. Cohen, one of the major developers of the program, maintained that "a program that is only for the poor—one that has nothing in it for the middle income and upper income—is in the long run a program the public won't support."\(^{52}\) Thus, from its early days, Social Security had a muddled mission. To support the program's welfare goals, the formula for calculating benefits at retirement was set to provide benefits that replace a larger share of past earnings for low-wage workers than for high-wage workers.\(^{53}\) But to maintain the allegiance of the majority, the program was given the trappings of an earned right, funded by worker “contributions”—actually a somewhat regressive payroll tax.\(^{54}\) And despite the provision for declining replacement rates as earnings rise, those with higher earnings still get higher benefits.\(^{55}\)

How effective is Social Security as an anti-poverty program? It is true that the poverty rate of people age sixty-five and older has declined sharply over the years—from about 35 percent in 1959 to 10 percent in 1999.\(^{56}\) Social Security played a significant role in that decline, although the general rise in income in the economy also contributed. However, at present, only a minor portion of Social Security's huge expenditures actually reduce poverty among the elderly. In fact, in 1999, it would have required only 20 percent of total Social Security expenditures to eliminate poverty altogether among men and women age 65 and over.\(^{57}\) Thus the bulk of benefits are paid to those who would not be poor in any event, while a small portion goes to those whose incomes without any benefits would have been below poverty by varying amounts. Moreover, Social Security provides no benefits or very low benefits to those who neither earned enough themselves to qualify for benefits, nor were married to someone who so qualified. And such individuals are among the poorest of the elderly. Viewed as a transfer

\(^{52}\) STEUERLE & BAKIJA, supra note 50, at 26.

\(^{53}\) Id. at 15.

\(^{54}\) Id. at 26.

\(^{55}\) Id.


\(^{57}\) Author’s estimate based on calculations from the public use file of the U.S. Census Bureau’s Current Population Survey (CPS), March 2000, which contains data on income of families and individuals in the preceding calendar year. See U.S. Census Bureau, Current Population Survey, available at http://www.ferret.bls.census.gov/macro/032000/pov/new01_004.htm (last revised Sept. 14, 2000). The CPS is the data collection instrument for the Current Population Reports. Poverty as estimated here is based on a measure of income that excludes Social Security and all other transfer payments. The calculation takes the difference between non-transfer income and the poverty threshold for each person age sixty-five and over and sums these differences. For unmarried persons the poverty threshold for a single individual is used even if they were living with others. Separate calculations were made for married couples. See id.
program, Social Security would not get high marks for cost effectiveness.

Social Security is frequently cited as an effective agent for income redistribution.\(^{58}\) However, within a cohort, the effects of the progressive benefit structure that would tend to transfer income to those with lower earnings are partly or even fully offset by other factors such as the greater longevity of higher earners and the payment of spousal benefits.\(^{59}\)

The program’s effects on saving and labor force participation are also questionable. In a pay-as-you-go system the working-age population is taxed to pay the benefits of current retirees. It is likely that the introduction of Social Security has led individuals to reduce their own private savings, expecting to substitute Social Security benefits for those savings. Because the flow of funds each year is a direct transfer from young to old, the system is likely a deterrent to net savings and capital formation. It is plausible that replacing part or most of the current system with a system of individual accounts in which individuals pre-fund their own retirement would increase national saving and contribute to economic growth.\(^{60}\)

It also is likely that by promising a relatively generous benefit at a politically determined age of retirement, Social Security has distorted the decision about when to retire and has contributed to the sharp decline in work participation over time among men age sixty-two and older.\(^{61}\) Work disincentives are greatest for

\(^{58}\) See generally Aaron & Reischauer, supra note 40, at 40–43, 92–93.


\(^{60}\) See James M. Poterba et al., Why Do Economists Disagree About Policy? The Roles of Beliefs About Parameters and Values 11–13 (Nat’l Bureau of Econ. Research, Working Paper No. 389), available at http://www.irs.princeton.edu/pubs/pdfs/389.pdf. Poterba suggests that there is considerable support in the economics literature for the view that a shift from the current underfunded system to a fully funded system would raise national saving. Id. He also reports on a survey of public finance economists conducted by himself, Victor Fuchs and Alan Krueger in 1997 asking what these economists thought was the effect of Social Security on the personal saving rate. Id. The median respondent indicated that the personal saving rate would have been three percentage points higher in the absence of Social Security. Id. But, not surprisingly, there was substantial dispersion in the estimated magnitude of the effect. Id.

\(^{61}\) See generally Social Security and Retirement Around the World (Jonathan Gruber & David A. Wise eds., 1999); see also Feldstein & Liebman, supra note 44, at 44 (reviewing and discussing other research on the topic).
low-wage workers who collect benefits that replace a high percentage of past earnings. Because Social Security provides only an annuity option, workers with shorter life expectancy, who are more likely to be low-wage workers, cannot receive a lump sum withdrawal and therefore face a “use it or lose it” proposition. Moreover, because there is no asset accumulation, there is no possibility for bequests. The extent to which a move to individual accounts would improve incentives to spread work over older ages would depend on the particular design of the system. However, there is much more room for flexibility in such a system that need not decree an arbitrarily set “age of retirement” and can allow for wealth accumulation with options for withdrawals and bequests.

VI. CONCLUDING COMMENTS

Public discussion about the financial health of Social Security usually focuses on the long run solvency of the system. Solvency can be measured in several ways. Popularly it is often expressed by the year the actuaries estimate the trust fund will be exhausted (currently, 2042). Alternatively, it is calculated as the present value of the difference between Social Security receipts and benefit outlays over the next seventy-five years or even in perpetuity—the infinite

62 See, e.g., Angus Deaton and Christina Paxson, Mortality, Education, Income, and Inequality Among American Cohorts (Nat’l Bureau of Econ Research, Working Paper No. 7140, 1999), available at http://dpl.nber.org/papers/w7140.pdf. Deaton and Paxson note that people whose family income was less than $5,000 in 1980 could expect to live about 25 percent fewer years than people whose family income was greater than $50,000. Id. at 1. They further explore the finding using both individual data and a panel of aggregate birth cohorts observed from 1975 to 1995. Id. at 16–34; see also Press Release, National Center for Health Statistics, Health in America Tied to Income and Education (July 30, 1998) (reporting on a study of the National Center for Health Statistics), available at http://www.hhs.gov/news/press/1998pres/980730.html. The findings are as follows: “Adults with less education tend to die younger than more-educated adults. Across the board, less-educated adults have higher death rates for all major causes of death, including chronic diseases, communicable diseases, and injuries.” Id.

63 Media attention is focused every year on the release of the Annual Report of the Social Security Trustees whose job it is to determine the solvency of the “trust fund” over a seventy-five year horizon. See, e.g., Mary Deibel, Social Security Fully Funded until 2042, STANDARD-TIMES, Mar. 18, 2003 at A15; Janelle Carter, Medicare to Run Out of Cash Sooner; Social Security Stronger Than A Year Ago, Associated Press, Mar. 18, 2003.

horizon. However, focusing on trust fund balances misstates the problem. Solvency measures can point out whether demographic trends are likely to be favorable or unfavorable. But by and large they do not raise the important issues relevant to system reform.

Why do we need a government retirement program? As noted, from its inception, the main goal of Social Security was to prevent destitution among the elderly, who by dint of their age are assumed to be less able to support themselves. But satisfying that goal would call for a much smaller program, focused only on the poor. The goal of universal coverage is often justified by the belief that the young are myopic and would not perceive the need to accumulate assets for their old age in the absence of a government mandate. However, a mandate does not require a pay-as-you-go program. The goal of compulsory saving can be attained more directly with a system requiring individual accounts and the accumulation of privately held assets. Many reform plans that propose “privatization” would combine individual accounts with a transfer component, funded on a pay-as-you-go basis. A transfer component can be designed to provide a safety net that addresses anti-poverty and redistribution goals.

It is surely difficult to design a new Social Security program with an individual accounts component. Among the many important issues to be resolved are the following: the size of the transfer component and the amount and type of redistribution to be incorporated; whether individual accounts should be mandatory or voluntary; the size of the contribution to an individual accounts component; the degree of choice given workers with respect to the composition of their investment portfolios; whether non-workers would be included (e.g., non-working spouses); and the manner in which transition costs would be funded.

Perhaps the most significant issue to be determined, however, is the overall size of a government retirement program. We are now richer and better educated than our parents and grandparents, and future generations will be more so. As a result, our ability to plan and direct our own lifetime savings should grow, particularly with changes in tax policy to eliminate saving disincentives. Thus in time we might plan for a reduced share of national income going to a government directed system of individual accounts in the expectation that voluntary saving would grow. The generosity of the pay-as-you-go component is also a particularly important consideration since the promise of a transfer that replaces a

65 See Trustees’ Report, supra note 3. As measured by the Trustees Report, both measures seriously understate the problem because they assume that the trust fund can accumulate assets that in turn bear interest. As discussed above, the trust fund has no mechanism for investing current surpluses to cover future shortfalls. Also see the discussion and estimates in Methods and Findings, supra note 64 confining the long term to the next seventy-five years much of the unfunded liability of the system is uncounted, since the Social Security deficit is expected to continue to grow after the seventy-fifth year.

66 See Steuerle and Baki, supra note 50, at 13–14.
significant share of earnings is a very good reason not to save. Under the current system, benefits for new retirees have been growing much faster than inflation because they are indexed to wage growth. One option is to reduce the growth of benefits in any pay-as-you-go component in future years, particularly for those with average or higher earnings. This could be attained by increasing the retirement age, or, preferably in my view, by transitioning to a price indexed system, a method suggested in the second of the three proposals of the President’s Commission on Social Security.