

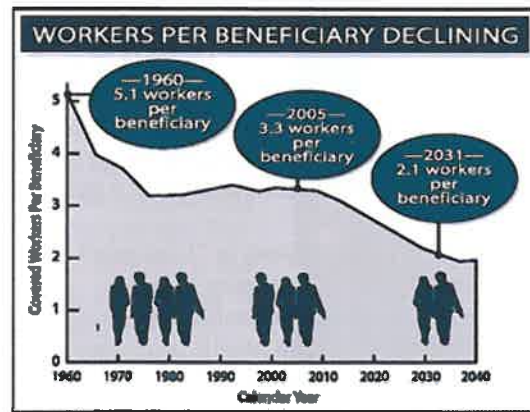
Social Security: Is There Really a Problem?

In early May, the trustees of the Social Security system released a report discussing the current and future financial health of program. Two dates jumped out of the report. First, the report stated that in 2017 (eleven years from now), the revenue collected in Social Security taxes will fall short of the benefits paid. Second, the report stated that in 2040 (36 years from now), the Social Security "Trust Fund" assets will be exhausted. Neither of these scenarios sound good, and they both, in some sense, seem to suggest that the system is going broke. Given the size of the Social Security system and the potential impacts on the economy of its going broke, it is worth sorting out which of these dates has real meaning and what can be done to forestall a bad outcome.

There is no doubt that Social Security is big. Each month nearly 50 million people receive Social Security benefits and more than 160 million people pay Social Security taxes. Given an adult population of about 230 million, the overwhelming majority of adults in the United States interact with the Social Security system in one way or another. The dollars are large, too. Each month the Social Security system pays out about \$45 billion (that's billion with a "b"), about 70 percent of which goes to retirees. The balance goes to survivors of wage earners and disabled workers. At the same time, the Social Security system collects about \$50 billion a month in tax revenue and interest on its assets, meaning the system is in surplus. In 2006, that surplus will be about \$60 billion and, by law, it will all be invested in Treasury securities.

Unfortunately, this happy state of affairs will not last much longer. As the baby boom retires, we will have more and more retirees and fewer and fewer workers. Add to the mix the fact that the birth rate is falling and that people are living longer, and the ratio of beneficiaries to workers is rapidly changing. (The fastest growing age cohort in the U.S. today is the 85 years and older group.) In 1960, there were 5.1 workers per beneficiary. Today that number has slipped to 3.3 workers per beneficiary, and by 2031 there will be only 2.1 workers per beneficiary. The "population pyramid" with lots of workers supporting just a few beneficiaries will become a "population rectangle" with the attendant increase in burden on the working population.

By Dr. Mike Bradley



Source: Social Security Administration

This demographic problem is exacerbated by the existence of "legacy debt." Forty years ago, Congress decided that the Social Security system would be a good tool to attack the problem of elderly poverty. Back then, about 30 percent of the elderly population lived in poverty. To attack this problem, Congress sharply increased benefits for then current Social Security recipients. This and subsequent benefit increases are credited with being effective at reducing elderly poverty.

Legacy Debt Adds Stress to System

Today, Social Security payments amount to almost 40 percent of all elderly income and two-thirds of Social Security recipients receive at least half of their income from Social Security. This means that current recipients receive benefits far in excess of what they contributed, and the difference between expenditures and revenues for current and previous beneficiaries is the "legacy debt." This means that benefits for future beneficiaries must be less than their contributions to pay the legacy debt, and this increases the financial stress on the system.

These structural imbalances bring into focus the problem facing the Social Security system and raise the issue of the "trust fund" to more than an academic debate. Recall that the trust fund is held solely in the form of Treasury securities, which are considered the safest, most reliable assets in the world. The United States government has never defaulted on its debt and is unlikely to do so in the future. This oft-quoted fact is generally presented as an argument that Social Security is on sound financial footing because its trust fund is worth \$2 trillion dollars and won't run out until 2040. But this argument takes only an "internal view" of

the Social Security program and doesn't explicitly recognize that the program is part of the overall federal budget. A broader view suggests a less optimistic interpretation of the trust fund.

This broader view is best understood by considering the financial situation of a married couple — the Ottos. Ben and Sarah Otto, although married, maintain separate checking accounts, credit cards, and financial assets. They each have a job, and they each do their own spending. Perhaps this is because of their different spending habits. Ben Otto is a spendthrift who enjoys eating lunch at fancy restaurants, wearing expensive clothes, and traveling first class. As a result, Ben routinely spends more than he earns. Sarah, in contrast, is thrifter and has historically earned more than she spends. Despite his spending behavior, Ben is scrupulously honest, and Sarah has no reluctance to lend him money to support his spending, as long as she receives an IOU for the proper amount. In this way, the Ottos maintain their financial stability as an economic unit. Things ran very smoothly for a number of years until Sarah decided to increase her spending in order to buy things for her sister. She was confident that it would be no problem because she had accumulated a large pile of IOUs from Ben, and Ben always made good on his IOUs.

But of course, Ben now has a problem. For he has been spending the money he borrowed all along and has no resources to pay back Sarah. To do so, he must increase his income, cut his spending, or both. Despite Sarah's justified faith in Ben's IOUs, the Otto family has no additional resources to support her increased spending.

When the IOUs Come Due

This is exactly the relationship between the Social Security Administration and the rest of the federal government. Social Security is a pay-as-you-go system in the sense that taxes on current workers pay the benefits for current retirees. In recent years, while the Social Security program has been accumulating sizeable surpluses, the rest of the government has been running sizeable deficits. Because the Social Security Trust Fund must invest in Treasury securities, it has been receiving IOUs from the rest of the government and the rest of the government has been spending that money. Thus in 2017 when the expenditures from the Social Security system will exceed its revenues, the rest of the government, like Ben Otto, will have a problem. How will it obtain the resources to make up the difference in the payments to the Social Security program? Like Ben, it will have to increase its income (higher taxes) or cut back on its spending.

Assuming that explicit benefit cuts are politically infeasible, solving Social Security imbalance from the inside requires some combination of raising the payroll tax rate (currently at 12.4 percent), raising the cap on wages that are taxed (currently at \$94,200), increasing the retirement age, and reducing the indexing (initial benefits are indexed to wage growth and subsequent benefits are indexed to the consumer price index.) Failing these corrections, the government will have to raise taxes or cut spending somewhere else in the budget.

Why Worry Now?

Either way, the government faces a serious adjustment. The discounted present value of the net Social Security shortfall over the next 75 years is estimated at \$4.6 trillion by the Social Security trustees. Yet, as indicated above, Social Security doesn't have any negative cash flow until 2017, and obviously the problem is small at first. Given that the crises won't hit until well into the future, why worry about fixing the Social Security program now?

Think of Social Security as a cruise ship that's set to go off course. A relatively minor change in a ship's position as it leaves port can cause a substantial correction in its position mid-ocean because the correction accumulates over distance. The need to move thousands of tons for hundreds of miles can be accomplished with very little fuel if the correction is made soon enough. Wait until the ocean liner is mid-ocean, however, and a substantial effort is required. The same is true for Social Security. Relatively minor adjustments to the tax rate, wage cap, and/or retirement age made now will accumulate over time and eliminate the need for major adjustments in the future. But given the rhetoric about Social Security coming out of Washington these days, it is hard to be optimistic that this sensible course will be followed. ●

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