Economic Conditions Affecting Social Security and the Merits of Pre-funding

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Committee on Ways & Means
U.S. House of Representatives

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Chairman McCrery, Ranking Member Levin, and members of the subcommittee, thank you for this opportunity to appear before you to discuss the economic conditions used to predict the future of Social Security and the merits of pre-funded benefits.

The late Herb Stein, who chaired the Council of Economic Advisers under Presidents Nixon and Ford, wisely recommended that we think in terms of "GDP budgeting." That is, we should not look at the federal budget in isolation, but in terms of how it is shaping the economy as a whole. Too often, our discussion falls into the trap of focusing solely on changes to government inflows and outflows and we fail to consider either the compounding or the dampening responses in the larger economy.

The fiscal challenge presented by Social Security represents a subset of the larger challenge of how our society will provide for more elderly people in the future. The consumption of future retirees will come almost entirely from the output of their working contemporaries. Retirees must finance their consumption through capital income, government transfers, or the generosity of their family and community. As we consider changes to Social Security, we should keep in mind the picture beyond the budget figures: How much pre-funding is realistic? Who stands to gain and who stands to lose? How much consumption should we sacrifice today to increase the consumption of more prosperous Americans in the future?

To prepare for a higher share of elderly people in our population, government policy should not focus on pre-funding but on providing stable macroeconomic conditions to facilitate strong economic growth. That means reducing the federal deficit enough to prevent the debt to GDP ratio from expanding. It also means managing the government's contribution to national saving in a way that keeps our foreign debt from rising as a share of GDP. We have done a poor job on both fronts in recent years. The federal budget should keep those two debt burdens under control and leave private actors to decide how much saving they want to do for themselves.

After weighing the effects on these broader questions of the proposals by the President and others to change Social Security, I conclude:

- Our society can manage the increase in the population over 65 relatively easily as an economic matter and with relatively modest difficulty as a fiscal matter because of productivity gains and the benefits of a smaller population under 20.
- Because middle- and low-income Americans rely so heavily on Social Security income, changes to the program should be made cautiously.
- The President's proposal on Social Security does not raise national saving and therefore does not improve the capacity of our economy to handle the coming increase in the population over 65.
- To "pre-fund" the costs of the Baby Boom's retirement, our society would have to produce more than we spend and, like the fabled ants, build up assets here and abroad to ease the transition to a more elderly society. Instead, we are worse than grasshoppers because we are eating up everything we produce and more.
- The federal budget contributed significantly to national saving in 2000 and 2001, but has subtracted from national saving in recent years.
- The President's proposal on Social Security requires substantial new federal borrowing with the goal of having middle-income retirees and survivors rely more on volatile capital income and less on more stable Social Security benefits.
- Were the President's proposal adopted, most Americans should decline the opportunity to create a personal account. Most people would come out losers most of the time because of the volatility of equity prices, interest rates, and inflation, plus the tendency to make bad investment decisions.
- Revenues of the Social Security trust fund are determined by the growth of wages[1] below the cap. The outlook for the trust fund has deteriorated since the early 1980s largely because wage growth has slowed and wages have become more unequal. The recent drop in the share of the population employed has hurt revenues.
- Future growth of trust fund revenues will depend on the growth of employment (for which immigration and the share of the population employed are the wild cards) and the growth of wages under the cap (for which productivity, the wage share of output, and spillover above the cap are important).

Demography presents a manageable economic problem

Doomsayers like to emphasize the demographic fact that the population over the age of 65 will soon grow much faster than the working age population. The numbers in this year's Social Security trustees report indicate that the ratio of the population over 65 to the population 20 to 64 will rise by 85% between 2005 and 2045. That extra burden sounds back-breakingly heavy when taken in isolation, but relatively modest when put in the proper context. First, consider the fact that the trustees' intermediate scenario projects productivity gains of 91% over that same period. That means that future workers will have far more income to share with the elderly.

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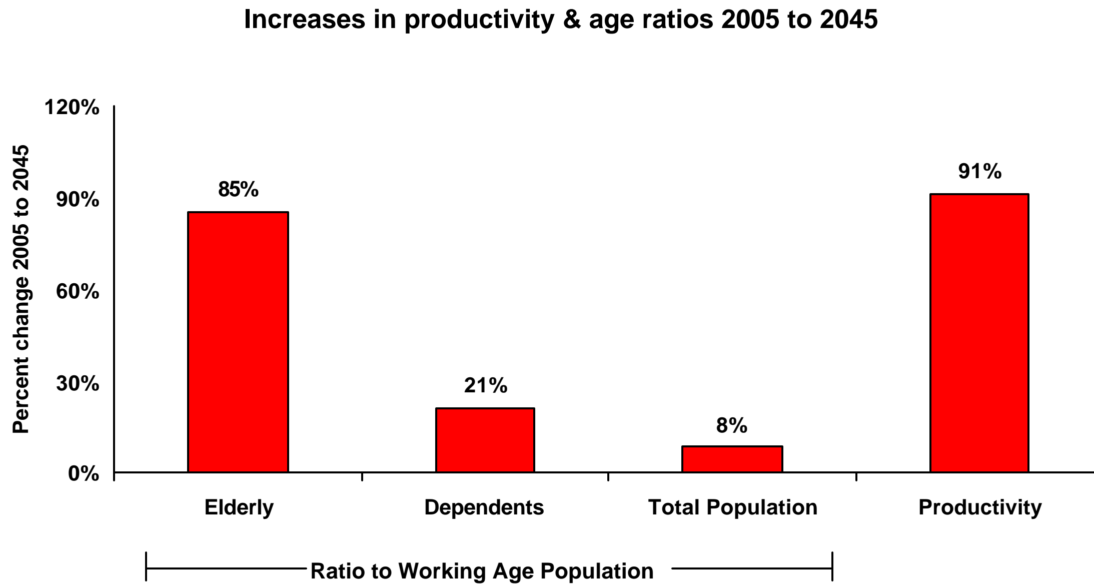
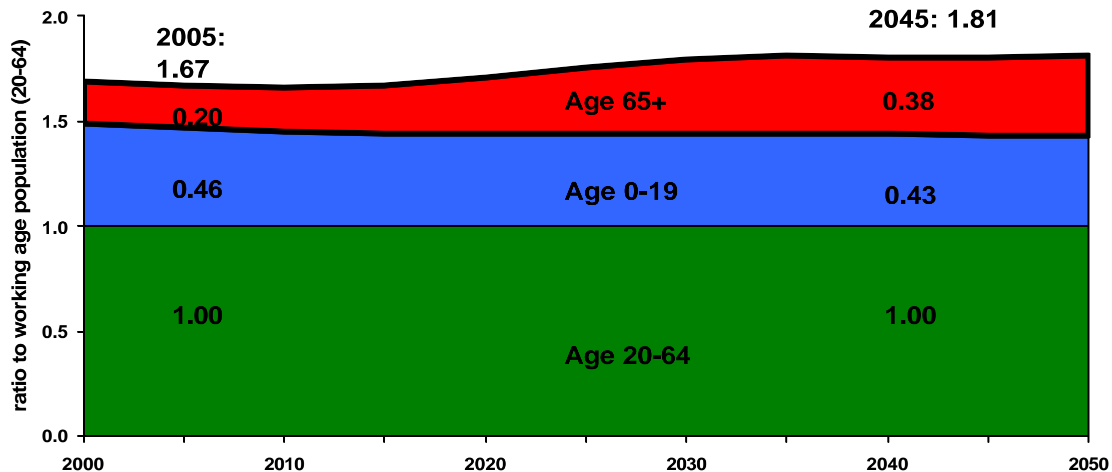
[1] Technically, wage, salary, and self-employment income are all subject to Social Security taxation. For simplicity, this statement often uses the term "wages" as short hand for all those forms of income.

Next, consider the fact that the working age population is not supporting just the elderly. Children are far more numerous than the elderly and their population will fall relative to the working age population. The trustees' intermediate numbers show only a 21% increase in the "dependency ratio," the ratio of the total of children plus the elderly relative to the working age population.



Working age people must support themselves, too. They consume more per person than any other age group and their share of the population is shrinking. The ratio of the total population to the working age population offers the best measure of the economic challenge posed by demography. That measure rises by only 8% over the next 40 years. With productivity gains of 91%, future workers will have ample room to support an additional 8% more people per worker and still enjoy far greater prosperity than we have today.[2]

[2] For further analysis, see Spriggs and Price. 2005. "Productivity growth and Social Security's future." EPI Issue Brief No. 208, Washington, D.C.: Economic Policy Institute.

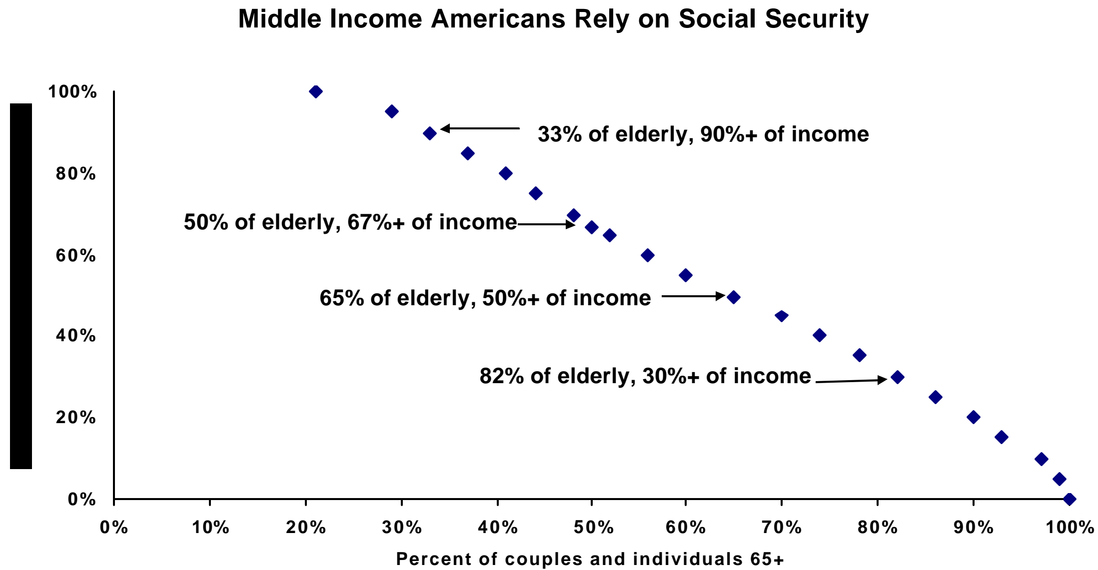


Demography has more pronounced effects on the federal budget than on the wider economy. As currently structured, programs aimed at children and middle-age people should shrink while those for the elderly grow. From that perspective, it is the compounding effect of demography with rising health care costs that presents a serious budget challenge. Assuming that the elderly should continue to obtain decent health, we should be developing policies that slow ballooning health care costs economy wide and not just squeeze on the federal budget part of the balloon. Taking the longer view, we can be confident that the medical technologies of two and three decades from now have not yet been invented. Other industries are raising quality while cutting costs. So can medical care. The federal government should use its considerable influence to foster new medical technologies that decrease rather than increase resource use. If we could change the path of medical technologies to make a significant dent in resource use in the future, that would have an enormous effect on future standards of living.

Proceed with caution: Middle-income Americans count on Social Security

Most people who have spent their working lives as middle-income Americans have come to rely on Social Security for their retirement income. One-third of Americans over the age of 64 receive at least 90% of their cash income from Social Security. For another one-third, Social Security supplies between 50% and 90% of income. Note that some of those people receive $20,000 from Social Security and $18,000 from all other sources. Such people would not be in poverty without Social Security, but they would notice a significant cut in benefits. The share of people with

over half of their income from federal programs would no doubt be higher if we could also take into account the value of their health benefits.[3]



Source: EPI analysis of CPS data

The privatization plan put forward by the President would substantially cut benefits for middle-income Americans who opt out of a private account. As we explain later, the effective cut is probably even deeper for most of those who opt in to a private account.

Middle-income Americans nearing retirement saw their retirement income prospects improve markedly between 1989 and 2001, but not for the reasons often assumed. The boom in the stock market largely passed them by. Christian Weller and Edward Wolff recently analyzed the Federal Reserve's Surveys of Consumer Finances for trends in sources of wealth for those approaching retirement.[4] For those between the ages of 56 and 64, they found median private pension wealth (including both defined benefit and defined contribution plans) actually declined from $54,000 in 1989 to $48,000 in 2001. Median non-pension financial wealth went from $15,100 to $23,200. Despite increases in home values, increases in mortgage debt caused net home equity to rise only modestly (from $65,700 to $70,000) for the median household.

For the broad swath of middle-income Americans approaching retirement, Social Security accounted for most of their gains in wealth between 1989 and 2001. Weller and Wolff examined the sources of improved wealth for the middle 60% of households (those between the 20th and 80th percentile). This wider group includes some people who

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[3] For further detail, including numbers by state, for women, for minorities, and for persons over 74, see Ettlinger and Chapman. 2005, "Social Security Income and the Elderly." EPI Issue Brief No. 206, Washington, DC.: Economic Policy Institute.

[4] Weller, Christian and Edward Wolff. 2005. "Retirement Income: The crucial role of Social Security." Washington, DC.: Economic Policy Institute. .

benefited modestly more from the stock market boom than those at the median. Yet, they found that, even for this broad group, the gains in estimated Social Security wealth dominated. Social Security wealth rose by $77,600, private pension wealth by $24,100, and all other forms of wealth by $28,500. For this group, the effect of the stock market was dwarfed by the effect of the strong labor market that caused wages to rise and, in turn, raised middle-income Americans' prospective Social Security retirement income.

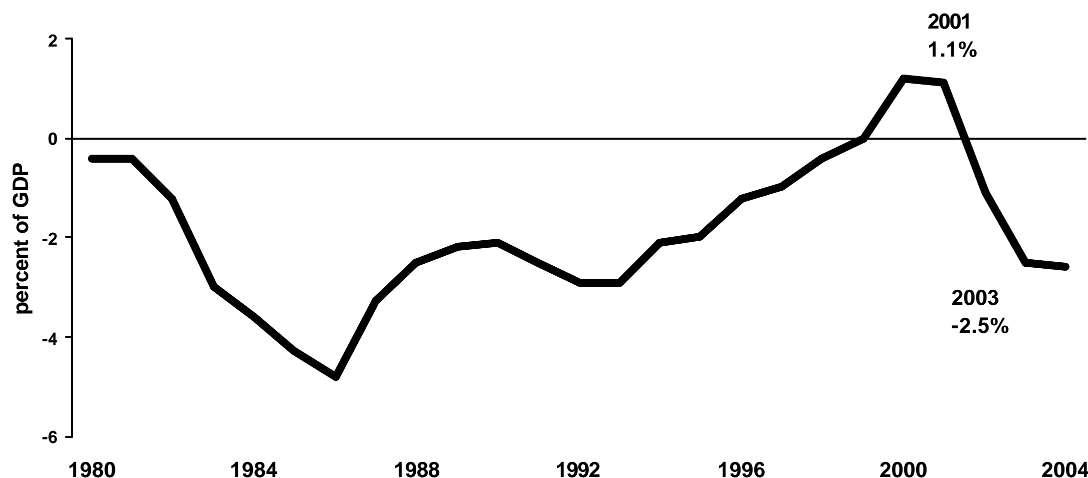
It is no coincidence that Social Security is the largest program in the federal budget and that so many Americans rely so much on it. While the budget numbers have alarmed many politicians and economists, we cannot lose sight of what major changes to the program would mean to actual people who rely on it.

Fiscal policy switched from pre-funding to de-funding future consumption

Pre-funding requires sacrifices. Whether in the budget or in the economy as a whole, it entails less consumption today for the sake of more consumption in the future.[5] Rather than sacrifice now to pre-fund part of the consumption of future retirees, we have effectively been *de-funding* future consumption in recent years. The evidence for de-funding is clear, by both the government and the overall economy. The deterioration of our fiscal balance since 2001 reflects decisions favoring current consumption over future consumption. Likewise, the collapse in our current account balance financed by the deterioration of our net international asset position reflects economy-wide decisions to consume more now and less in the future.

The CBO has devised a measure to identify the effects of policy changes by excluding the effects of the business cycle and other transient effects. Fiscal policy is moving in the direction of pre-funding when this measure (the standardized-budget surplus or deficit) is rising and in the direction of de-funding when this measure is falling.

[5] As discussed later, the case for public policy to impose sacrifice today on behalf of more prosperous future generations is problematic.



Source: Congressional Budget Office

With help from the 1983 Social Security legislation, overall fiscal policy moved in the direction of pre-funding from the mid-1980s through 2001. We have moved in the direction of de-funding since 2001. The CBO estimates that the standardized budget had a balance of - 3.0% of GDP in 1983 and hit a low of - 4.8% in 1986. The policies that drove the standardized balance down between 1983 and 1986 had largely been adopted at the time of the Social Security agreement. Over the next 15 years, the standardized budget had an average deficit of 1.5% of GDP. While not a surplus the size of the Social Security surplus, that record showed an effort to pre-fund, or at least to stop de-funding future retirement costs.

We should put the fiscal decisions since 2001 into the context of today's discussion of pre-funding Social Security. The standardized budget fell from a 1.1% of GDP surplus in 2001 to a 2.6% of GDP deficit in 2004, for a decline of 3.7% of GDP. The entire 75-year shortfall in Social Security has been estimated to be 0.7% of GDP by the SSA actuaries and 0.4% by the CBO. In other words, the fiscal policy changes between 2001 and 2004 worsened our fiscal balance by five to nine times as much as it would take to fully fund Social Security for 75 years.

In relationship to our deficit today and projected into the future, the funding shortfall for Social Security remains modest. If the goal is to address our long-term fiscal issues, we should paying more attention to health care and revenues, but not in the way those issues have been addressed in recent years.[6] Indeed, the enactment of permanent tax cuts and under-funded prescription drug benefits stand out as decisions that favor consumption earlier rather than later, and they grow in cost. Over the next 75 years, the

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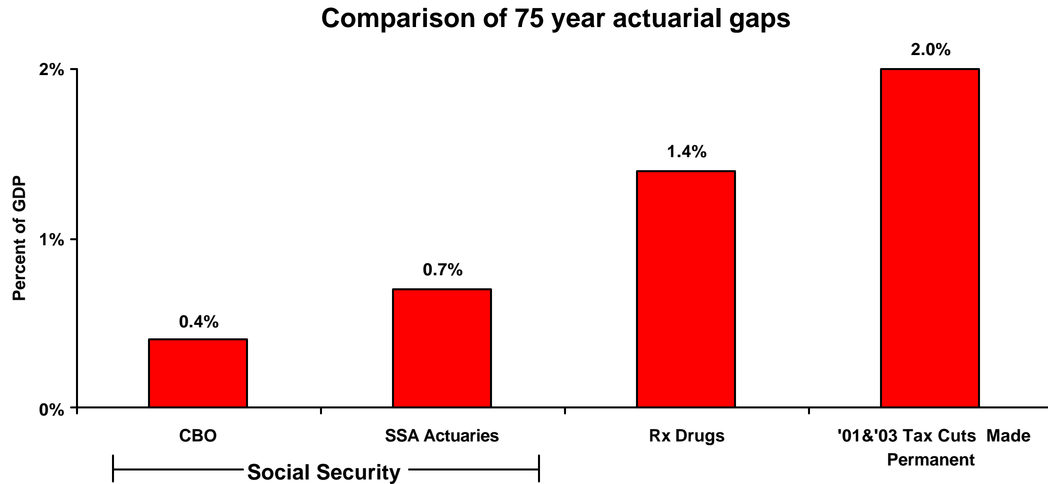
[6] For further analysis of the relative unimportance of Social Security in our larger fiscal challenges, see Sawicky, Max. 2005. ""Big deficit, little deficit: The Bush budget and Social Security." EPI Snapshot May 23, 2005, Washington, DC.: Economic Policy Institute and Sawicky, Max. 2005. "Collision Course: The Bush budget and Social Security." EPI Briefing Paper No. 156, Washington, DC.: Economic Policy Institute.

tax cuts have been estimated to create a shortfall of 2.0% of GDP. The prescription drug bill added another hole estimated at 1.4% of GDP. Clearly, our government has had other priorities than to pre-fund some of the Baby Boom's retirement.



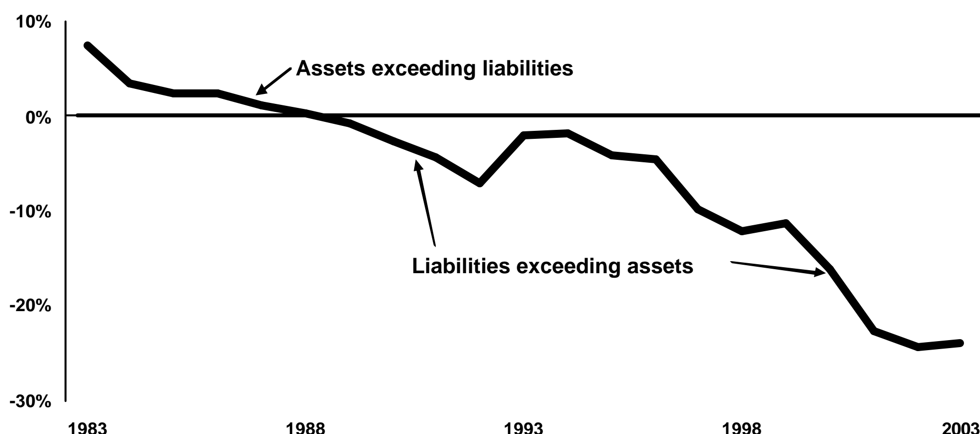
Source: Center on Budget and Policy Priorities

Economy-wide we've been de-funding for some time

Although our fiscal policy was moving in a favorable direction for pre-funding for the decade and a half prior to 2001, the same cannot be said for our nation as a whole. Last Friday, the government reported that we ran a current account deficit of $780 billion at an annual rate in the first quarter, a record 6.4% of GDP. In other words, we are spending 6.4% more than we produce as a nation. In contrast, Japan and Germany justify their large surpluses as appropriate preparation for the fast growth of their retired population.

Some have argued that an increased current account deficit is justified if it finances more investment in the U.S. That argument has both factual and theoretical flaws. As a factual matter, investment has not been particularly strong. Second, even if there were greater investment, it would be raising GDP (output within our borders) but would not be raising the future income of Americans. To finance our habit of increasing consumption faster than our output and income, we are selling off assets in the U.S. at a rapid rate. Those assets give persons abroad an increasing claim to our future output. The value of foreign-owned assets here now exceeds the value of U.S.-owned assets abroad by $3 trillion, a quarter of our GDP. And we are going into hock abroad at a rapid rate. As we sell off our assets to maintain our trade deficit habit, we mortgage off our future GDP to people abroad.[7]

[7] The net liability position did not rise in 2003 because of the rise in the dollar against currencies (particularly the Euro) with large U.S. assets abroad. Ultimately, large current accounts translate into deeper net liabilities.



No pre-funding with private accounts

To my knowledge, no Social Security proposal under debate today provides for any significant pre-funding by reducing current national spending to finance higher benefits in the future.

The President's proposal creates private accounts with borrowing and not spending cuts. As the Administration has conceded, this proposal does not raise saving and therefore has no pre-funding. Because the President's latest budget actually raises the deficit over the next five years, it makes no effort at pre-funding the retirement of the Baby Boom.

Likewise, the proposal to create private accounts to the extent of the current $163 billion Social Security surplus would involve even more borrowing initially than the President's plan. A serious pre-funding plan would have an attainable sacrifice initially and grow over time. The plan to finance private accounts with the Social Security surplus starts out large and dwindles to nothing in a decade.

Pre-funding and fairness

Because the people who pay for pre-funding often differ from the people who benefit, we should carefully consider questions of fairness in proposals for pre-funding. Two fairness questions come to mind. First, what are the implications of changing the pre-funding arrangements of 1983? Second, how much should we sacrifice to future generations who will be far more prosperous than we are today?

Pre-funding played an important part in the 1983 compromise on Social Security. To achieve 75-year actuarial balance with the Baby Boom generation's retirement already looming, the 1983 agreement raised payroll tax revenues above expected benefit payments for the first half of the period to offset a revenue shortfall in the second half. To claim progressive benefits in retirement, the Baby Boom would have to pre-fund the system with regressive taxes. Now, after 22 years of paying regressive payroll taxes to pre-fund the system, Baby Boomers born after 1949 are being told that they must accept benefits cuts because of a newly found crisis: a cash shortfall. In fact, the actuaries projected in 1983 that program costs would first exceed revenues in 2020, the same year that CBO now projects. Despite many claims to the contrary, it's hardly a crisis when the date for the end of the cash surplus has been known for 22 years.

Although thrift may always seem virtuous, the economic and moral case for pre-funding is debatable. Consider this thought experiment. The Social Security trustees report projects that our per capita income will rise about 80% over the next 40 years. Per capita income in Connecticut exceeds that of Mississippi by about the same percentage today. No one would expect the people of Mississippi to sacrifice today so that the people of Connecticut can consume more today. Does it make any more sense for people today to sacrifice to raise consumption even higher in the future? It's one thing for us to decide to save as individuals, but it's another thing for you as representatives to decide that the nation must cut today's consumption for the sake of higher future consumption.

Most would lose money with the President's private accounts because of big risks

It is unlikely that most people would come out ahead if they chose to set up a private account as proposed by the President. People would be asked to bear substantial risks that they would not face if they opted out of creating a private account. In simulations by Professor Robert Shiller, investors in the President's plan would be expected to lose money 71% of the time. Using historical performance of global market indexes and projections of likely returns in a recent survey of experts by the *Wall Street Journal*, he estimated a median return of 2.6% above inflation, less than the 3.0% charged by the President's plan. (Note that Shiller's calculations do not reflect the decisions of actual people who, as explained below, tend to underperform a balanced portfolio of indexes.)

Some features of the President's proposal – and the attendant risks -- have not received the attention that they deserve. Once a person opts to start contributing to a private account, she must do so until benefits are triggered by retirement, death or disability. If a 25-year-old decides to climb on board, they are strapped in to a roller coaster ride and cannot get off before they retire, die, or become disabled.

Consider the multiple ways that the President's plan exposes private account holders to risks of inflation. First, take the fact that people are charged interest at the rate of 3% plus inflation for any Social Security taxes diverted into a private account.

Economists and accountants like to subtract inflation in making long-term forecasts because they don't have confidence in forecasting inflation. But the President's plan asks a 25-year-old who puts $1,000 into a private account to take a risk about the inflation charge for the 42 years until he retires. In the long term, stocks and bonds may adjust to higher inflation, but not in the short to medium term. For example, unanticipated inflation in the 1970s was accompanied by a bear market in stocks and a slump in bonds.

Second, there is the risk of inflation after benefits begin. Current Social Security benefits are indexed for inflation, which puts the risk of higher inflation primarily on the government. Recognizing the risks involved, the private market has been reluctant to provide inflation-protected annuities. If they are offered in the future, they will come at a hefty price in terms of reduced annuity payments.

Another risk involved with private accounts comes from the volatility of interest rates. When a person retires, her monthly annuity payment depends on the amount of money used to buy the annuity and the current interest rate. The lower the interest rate at the time of retirement and annuity purchase, the lower the annuity payment until death. A person who traded in a stock portfolio for an annuity in early 2000 would have a much higher annuity than someone who did so in recent years not only because stock prices have declined but because interest rates did, too.

Finally, in deciding whether to create private accounts with Social Security funds, Congress should consider the evidence that most people manage their investments poorly. Because they appear to buy and sell based on trends, they tend to buy high and sell low. This result holds not just for specific stocks but for broad mutual fund categories of the type proposed by the President.

Ironically, those most eager to manage their investments seem to do the most poorly on average. Recent polls suggest that men are more likely to support private accounts than women. But note that recent research has found that men were more active traders and had significantly lower returns on their accounts than women.

Private accounts have been touted as a "sweetener" to help the public accept sizeable benefit cuts that deepen over time. Given all the risks involved, however, people should assume that opening a private account will reduce their retirement income even further.

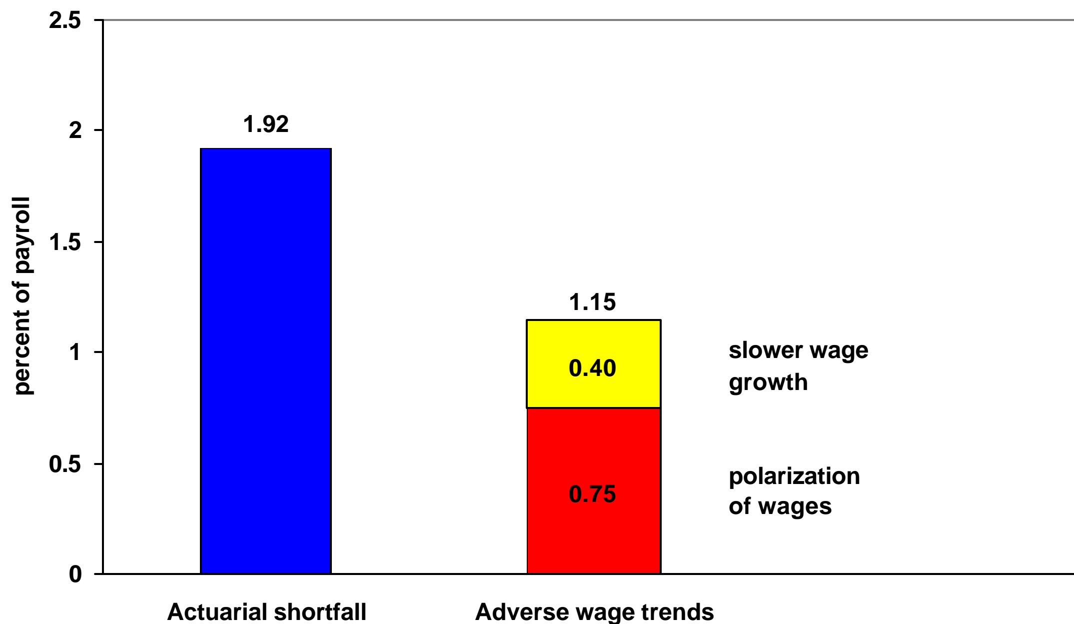
Adverse wage trends have hurt the Social Security trust fund

Two adverse trends in the labor market have had a substantial negative effect on the Social Security trust fund since 1983. The Social Security actuaries have estimated a 75-year shortfall of 1.92% of payroll. The Social Security trustees have lowered their projected growth rate for real wages from 1.5% in 1983 to the current projection of only 1.1%. Slower wage growth causes revenues to fall more than benefits within the 75-year window. SSA actuaries project that real wage growth of 1.5% in the next 75 years would

narrow the projected shortfall by 0.40% of payroll – about a fifth of the projected shortfall.

The increased inequality of wage income has contributed even more to the shortfall. The cap on wage and salary income subject to Social Security taxes (now $90,000) has been rising with average annual earnings. Although the share of earners above the cap has remained about 6%, their earnings have risen much faster than average. As a result, the share of wage and salary income not subject to Social Security has risen from 10% to more than 15%. (Recent evidence for 2004 suggests this untaxed share has widened further.) SSA actuaries estimate that covering 90% of wage and salary income over the next 75 years would narrow the shortfall by 0.75% of payroll – two-fifths of the projected shortfall.

We would face a shortfall about 40% as large as they one projected today if, all else equal, real wages were still expected to rise at the rate projected in 1983 and wage and salary income had not become more unequal.[8]



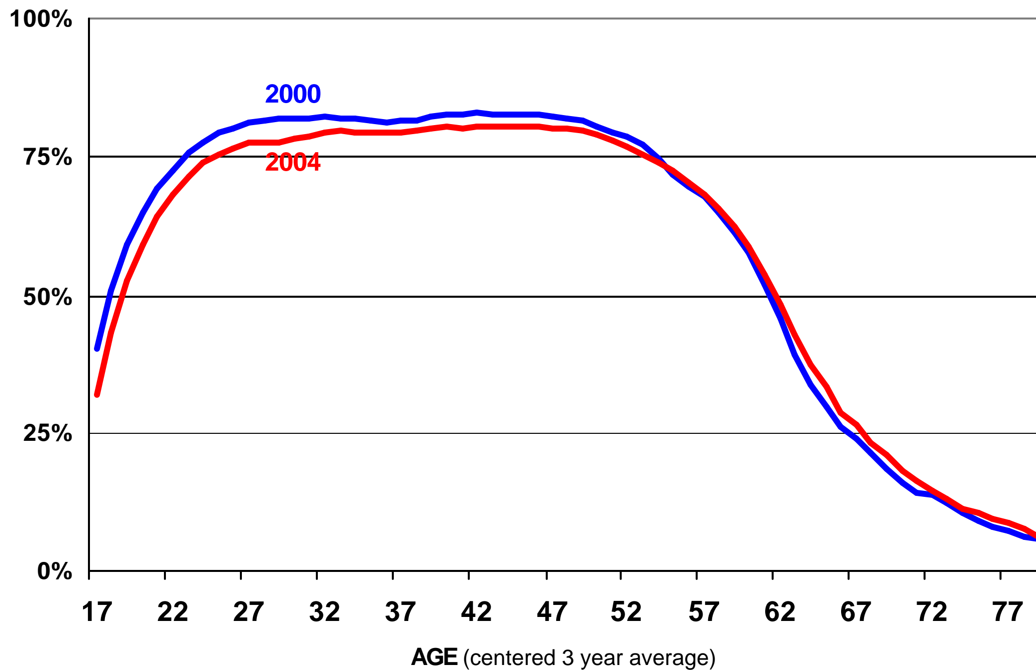
Future health of the trust fund depends on a healthy labor market

Social Security revenues are a function of how many people are employed and how much of their wage income is subject to Social Security taxes. The number of

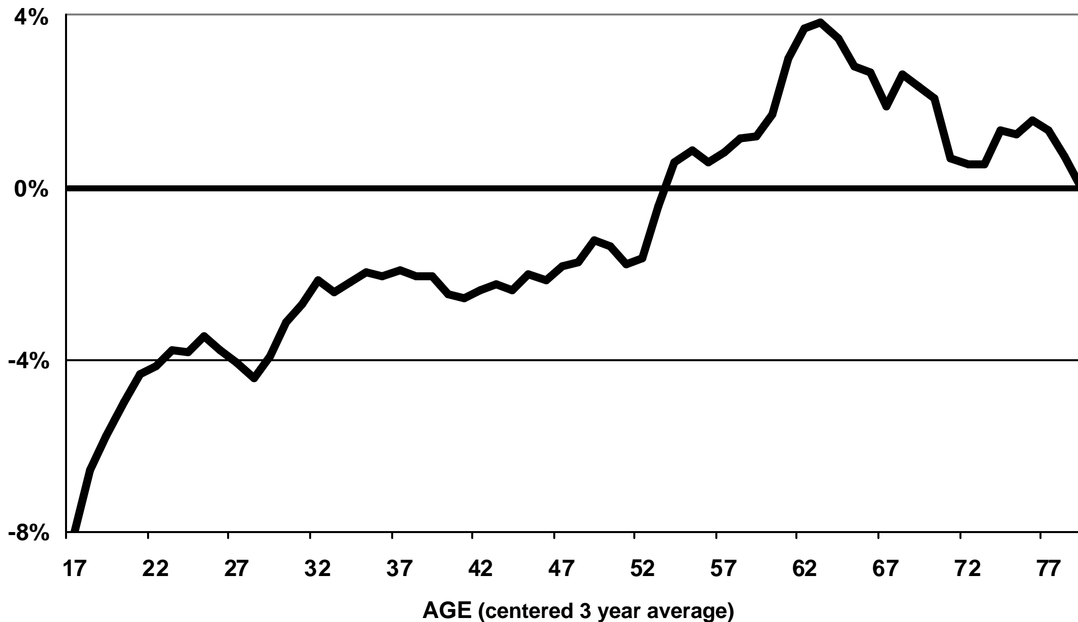
[8] For further analysis, see Bivens, L. Josh. 2005. "Social Security's fixable financing issues: Shortfall in fund is not inevitable." EPI Issue Brief No. 207, Washington, DC.: Economic Policy Institute.

people employed is a function of the population and the share of the population employed. Immigration appears to present a bigger question mark for future population growth than domestic demography (births and deaths). The trustees projected immigration of 900,000 a year for each of the next 75 years in their intermediate projection and 1.3 million a year in their low-cost projection. With the population of the U.S. and the rest of the world growing and global transportation and communication becoming cheaper, it seems implausible that immigration would remain fixed. If immigration grows at a modest 1% per year from recent levels, it will more than triple the intermediate projection and double the low cost projection within 75 years.

As a matter of logic and recent experience, the employment to population ratio matters more to future employment than the unemployment rate. In recent years, the unemployment rate has gone haywire as an indicator of potential employment. The chart below compares the employment to population ratio for each age level for 2000 and 2004. Note that in both years employment falls sharply well before age 62. This belies the comfortable assumption that people hold a steady job until they start claiming Social Security benefits at age 62.[9]



[9] For further analysis of this point, see Gould, Elise. 2005. "Many already lack a steady job before the Social Security retirement Age." EPI Snapshot June 15, 2005, Washington, DC.: Economic Policy Institute



Note also that the ratio was uniformly lower in 2004 for ages up to the mid-50s and uniformly higher for older ages. The second chart indicates the size of the 2000-2004 change for each age level. The decline was 2% to 4% of the population from the mid-20s to the mid-50s.[10] That represents a decline in employment for more than 3 million prime working age people. If we can restore normal job growth in the range of 300,000 jobs a month instead of the anemic 170,000 jobs of the last six months to a year, it would do wonders for the trust fund coffers. If the employment to population ratio remains depressed, it bodes poorly for the trust fund.

Wage income subject to Social Security taxes is affected by productivity, labor's share on income, the wage share of compensation, and the share of wages below the cap. Fortunately, productivity has improved markedly in the last decade. Labor shared in productivity gains in the 1990s, but its share of the gains since 2001 has been extraordinarily low. Squeezed by a falling labor share of income and rising health benefit costs, wages have grown slowly in recent years. The continued disappointment in wage growth despite strong productivity gains was a major factor accounting for the trustees' decision to advance the projected dates for the trust fund cash flow to turn negative and for the trust fund to be exhausted. On the other hand, if productivity gains of the last decade are sustained and labor's share of those gains reverts to historical norms, then the trustees' projections for taxable wages are too pessimistic.

[10] Separate analysis shows no difference in the decline for men and for women.

The share of taxable wage and salary income below the cap represents another key variable. As noted earlier, people making income above the cap have enjoyed faster than average wage and salary gains since 1983. That trend abated somewhat with the downturn in financial markets and technology companies. This year's data on tax revenues and anecdotal information about a revival of bonuses and stock options suggest that the share of income above the cap is rising again.

Unlike other economic variables, the share of wages over the cap can readily be fixed by legislation. The cap does not have to move at the rate of average wages when high income wages are growing faster. The cap could be raised to maintain a fixed share of income above the cap or to restore the 90% coverage of 1983. If the cap is removed altogether, the trust fund would no longer be hurt by greater wage inequality.

Conclusion

Most middle-income Americans have come to rely on Social Security to protect their families in retirement, disability, or early death. In a world of topsy-turvy labor and financial markets, the Social Security system provides a port in the storm.

Pre-funding the retirement costs of future retirees requires sacrificing current consumption in favor of future consumption. Policy decisions in recent years have turned in the opposite direction. Between 2001 and 2004, policy decisions reduced the federal budget balance by 3.7%, more than five times the annual average shortfall that SSA actuaries project for Social Security. Both the prescription drug legislation and the tax cuts of 2001-2003 have 75-year fiscal effects that are multiple times as large as the Social Security shortfall. As a nation, we are rapidly selling off our assets to persons abroad

The rhetorical argument that private accounts can materially offset the cuts proposed by the President does not bear close scrutiny. Indeed, if Congress enacts the President's plan for private accounts, the private accounts may have few takers because the odds are stacked against the typical investor coming out ahead of the "clawback" interest charge.

Economic variables important to the trust fund include immigration, productivity, the share of the population employed, the share of output received by labor, the share of labor compensation paid as wages, and the share of wages paid below the cap. The trustees were probably too pessimistic on the first two variables, but recent trends on the other variables are worrisome.

Of all the variables with a significant effect on the trust fund, the one most under the control of Congress is the amount of wage income above the cap. Congress should revise the formula for the cap to prevent future erosion. Eliminating the cap altogether would prevent increased wage inequality from eroding trust fund revenue. Otherwise, a return to a normal pattern of gains in both employment and wages would do wonders both for Social Security beneficiaries and for the trust fund.