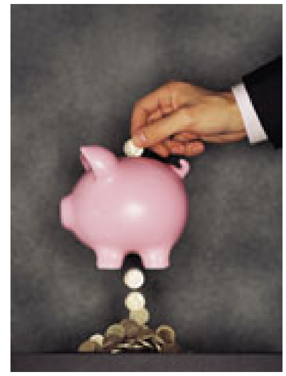
Knowledge@Wharton

Is Social Security in Trouble? Depends on Whom You Ask

Published : January 26, 2005 in Knowledge@Wharton



President Bush has launched his promised campaign to revamp Social Security, arguing that future funding shortfalls could be made up by allowing workers to put part of their contributions into investments under their own control. Opponents such as AARP, the organization for retired people, say his plan would destroy the 65-year old safety net, slashing benefits received by older Americans.

Differences on the issue are so wide that the two sides cannot even agree on the threshold question: Is the Social Security system really in financial trouble?

"The answer is, it depends on your time horizon," says Brigitte C. Madrian, professor of business and public policy at Wharton. "There is no crisis tomorrow. There is money, benefits will be paid ... But at some point in the future the money is going to run out, and at that point there are two choices: increase taxes or cut benefits. And neither one of those is particularly palatable."

Most everyone agrees the system is currently well in the black. The 12.4% payroll contributions divided evenly between workers and their employers exceed the payout to current beneficiaries. This has allowed $1.5 trillion to accumulate in a reserve "trust" that holds U.S. Treasury bonds.

Most also agree the system could keep running pretty much as is for decades. Contributions will exceed payouts until about 2018. After that, as more and more baby boomers retire, to be supported by fewer workers, contributions will lag payouts, with the difference drawn from the trust. If no changes are made, the system should continue to pay full benefits until at least 2042. After that, benefits would have to be cut by about 30%.

The big question is what happens way down the road. The Social Security Administration says the system is $3.7 trillion short of what it needs to maintain the current level of benefits over the next 75 years, the standard period for evaluating the system's health. Groups like AARP and many Democrats say that's a modest sum spread over such a long period -- small enough to be made up with minor changes such as a slight payroll tax increase, a slight cut in benefits or raising the age at which retirees can receive full benefits.

Calculations by the Social Security Administration conclude that the 75-year shortfall could probably be made up by raising the payroll tax 1.89 percentage points -- to about 14.3% from the current 12.4%, says An Andrew B. Abel professor of finance and economics at Wharton. The SSA's worst-case view says the tax would have to be raised about 5 percentage points, while the best-case suggests taxes could actually be reduced about 0.4 percentage points.

The differences depend on assumptions about life expectancies, fertility rates and other factors. "It's impossible to forecast accurately over that period," Abel cautions. An increase in immigration, for example, could pump young workers into the system as baby boomers retire, bolstering payroll contributions and forestalling deficits, he says.

The President evaluates Social Security with an infinite time horizon, arguing the system is about $11 trillion short of what it needs to permanently assure that the current level of benefits, adjusted for inflation, is paid. Hence, more dramatic changes are required, he says.

"Debating Social Security into Perpetuity"

Kent Smetters, professor of insurance and risk management at Wharton, believes the administration is correct in using an infinite horizon. The 75-year approach ignores the likelihood that the system will be in terrible shape right after that period ends, when the trust is depleted and workers' contributions fall far short of benefits paid to retirees, he says.

If the 75-year horizon is used, 15 years from today policy makers will have to worry that the system will be in crisis after another 60 years -- that it fails the 75-year solvency test, according to Smetters. "The irony about this is we would be debating Social Security into perpetuity."

In fact, a commission led by Alan Greenspan, currently the Federal Reserve Chairman, recommended a number of fixes in 1983 that were designed to keep the system solvent for 75 years. Today, a 75-year view covers about 20 years not considered by the Greenspan group. "We supposedly fixed Social Security for a 75-year period in 1983," Smetters notes. "Over 60% of today's problem is from the 75-year window moving over time." Many academics, as well as an advisory group appointed by President Clinton in the mid-1990s, have used the infinite horizon, he adds. "This is not some right-wing perspective."

Whether the 75-year or infinite horizon is best is "a tough question," Madrian says. A very long horizon obviously forces policy makers to think long-term, but "it is extremely difficult to project what is going to happen 100 years in the future."

During his first term, Bush appointed a commission which endorsed the concept of personal accounts for addressing future shortfalls. The President stipulated that any solution not include increases in the payroll tax, and he barred the commission from proposing that the government invest part of the trust in the stock market, the way many public and private pension funds do. Bush's restrictions led some critics to complain that the President's commission did not make an honest evaluation of all possible remedies.

The President has promoted private accounts without providing many details of how they would work. Generally, they would allow workers to put some portion of the payroll deduction into accounts they would control, as they do with 401(k)s. They would make the investment choices, probably from a selection of government-approved mutual funds, and they could pass any unspent assets in the accounts to their heirs.

In exchange, the guaranteed Social Security benefit would be reduced, though the administration has not said by how much. In theory, the healthy returns offered by stocks would allow the private accounts to grow enough to offset the benefit cut. The President has said people in and near retirement would continue to get the benefits currently promised. He has not said whether participation in private accounts by younger workers would be voluntary or required.

Diverting money to private accounts would actually worsen the shortfall in the Social Security trust by some $2 trillion, according to some estimates. But the administration says this would be offset by the savings as future benefits are trimmed.

Critics point to many studies that have found workers do a poor job managing their 401(k)s, typically earning returns far below market averages. Also, they say, there is no guarantee stock returns will be as strong in the future as they were in the past -- a key assumption among private-account advocates. Clearly, private accounts would shift risk from the government to the worker, just as 401(k)s, in replacing traditional pensions, shift investment risk from employer to employee.

Madrian notes that a flood of new cash into private accounts could dampen stock returns by shifting the balance of supply and demand. "We don't have a good sense of what might happen." In the meantime, she adds, private accounts would clearly force beneficiaries to take on more risk than they do with the current guaranteed-benefit system.

Stocks have historically been riskier than bonds and cash. With private accounts, some beneficiaries might be big winners, others big losers. Moreover, periods of sustained stock-market slumps might leave the average beneficiary with less than today's system would provide.

Benefit Cut by Stealth

Another change reportedly considered by the administration would affect the way benefit levels are adjusted for inflation. Currently, the starting benefit level goes up each year according to an index of American wages. Once a retiree starts receiving benefits, annual increases are tied to the consumer price index.

Historically, wages rise faster than prices, causing a gradual improvement in the standard of living. The Social Security benefit of a person retiring today thus has more buying power than the benefit paid someone retiring 10 or 20 years ago, even if the two people had identical work histories.

Many reports say the President will propose that starting benefit levels be indexed to prices rather than wages, reducing the government's future obligations. "If you did that, you would solve the Social Security [funding] problem," Smetters says.

While the AARP argues that over time this will cut the average beneficiary's buying power in half, Smetters suggests that a future benefit would buy the same basket of goods it would today; it would *not*, however, buy a larger basket of goods, as it would under the current wage-indexing formula. "Price indexing really turns Social Security into more of a poverty-relief program and less of a pension program. If they're not going to increase the retirement age, I think that's the only option." Madrian agrees. "I think it makes sense to index to prices rather than wages."

But Abel argues that switching to price indexing is a benefit cut by stealth that makes it difficult for people to figure how well their benefits will replace their pre-retirement income. It would be better, he says, to adjust the income-replacement formula used in calculating benefits. Another option would be to increase the age at which people can begin receiving full benefits, but this puts a burden on people with physically demanding jobs, he adds.

According to Madrian, ideally the system should be completely redesigned to reflect the vast changes in American society since the system was created in the 1930s. Today, people live much longer in retirement, more women work, and there are many different types of families. During the Depression, when Social Security was established, the government wanted to encourage older people to leave the work force; now it needs them to stay. "We are living with a system that is very outmoded, and if you were to design a system from scratch it would be very different ... I think we need a system that moves away from looking at families to looking at individuals." She notes, though, that a top-to-bottom overhaul is not politically feasible today.

By pushing private accounts, Madrian suggests, the administration can claim it is reforming Social Security without really getting at many of the problems that need to be addressed, such as the inequitable treatment of various participants. And, she adds, it's not possible to fully evaluate the private account proposal with so many issues left unclear, such as the size of the accompanying cuts to the traditional benefit.

The administration says it will have a more detailed proposal in March. "There are lots of ways to design the system, and the Bush administration has not hung its hat on one particular choice," Madrian says. "The devil is always in the details."