IRET Congressional Advisory

May 14, 1996 No. 54

SOCIAL SECURITY RETIREMENT AND DISABILITY PROGRAMS NEED HELP NOW

The 1996 Social Security Trustees Report, to be released in early June, will reaffirm that the retirement and disability portions of the Social Security System -- Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) -- are headed for serious trouble. This Advisory is to remind the Congress that the retirement and disability programs are broken, and that they require attention *now*, not at the last minute when they are about to begin delaying benefit checks. Future advisories will show why patching up the current system is not feasible and will suggest ways of replacing Social Security with real saving by individuals for their own retirement and with private disability insurance.

> ***The [Social Security] retirement and disability programs are ... broken, and ... require attention now, not at the last minute when they are about to begin delaying benefit checks.***

Unchecked growth of entitlement spending will trigger a budget disaster as the baby boom generation retires. Congressional Budget Office projections presented by the Bipartisan Commission on Entitlements and Tax Reform (Final Report, Washington, DC, January, 1995) show a very serious situation. Even if discretionary spending is strictly controlled, federal deficits will rise sharply. By 2010, rising entitlement outlays and interest on the debt will absorb nearly all federal revenue, with almost nothing left for defense and other discretionary federal spending. (See chart.) Soon after 2020, entitlement spending alone will exceed federal revenues. The deficits in the major entitlement programs (outlays in excess of payroll tax receipts and Medicare premiums) will drive up the national debt, and the compounding debt will cause interest outlays to explode. Federal deficits will rise from about 2.3% of GDP in 1995 to almost 19% of GDP by 2030. The deficits would absorb every penny of gross national saving, which has been running between 14% and 19% of GDP in recent years. Virtually all domestic saving would be required simply to service the federal debt. Nothing would be left for maintaining or increasing the stock of capital.

Clearly, entitlement spending must be controlled. The sooner that steps are taken to deal with soaring entitlement spending, the better. The longer changes are delayed, the more wrenching they will be.

Social Security's impact on the economy

Social Security is already adversely affecting employment, saving, and investment. Rising payroll taxes have discouraged effort, reduced the supply of labor, and driven up labor costs. Higher labor costs force businesses to hire fewer people than they would otherwise employ. A good rule of thumb is that each percentage point increase in the payroll tax reduces employment by about one-third to one-half percentage point. Labor intensive businesses are hit the hardest by the tax, but all U.S. businesses suffer from the higher labor costs in the highly competitive world economy.

The amount of income subject to the payroll tax has risen from $3,000 in the 1940s to $62,700 in 1996. The combined OASDI payroll tax rate for employers and employees has climbed from 2% of payroll in the 1940s to 12.4% today. The rate is

15.3% with Medicare. For most working taxpayers, the combined payroll tax is larger than the income tax.

Social Security also reduces saving and investment. By reducing the labor supply and employment, the payroll tax indirectly reduces the productivity and earnings of capital and discourages saving and investment. Insofar as people still believe that they will receive substantial benefits when they retire, the program cripples one of the biggest motives for personal saving. Taxation of Social Security benefits punishes all who save and reduces saving by people of all ages. It also discourages work by current retirees, reducing the labor force. The Social Security earnings test reduces the labor supply and raises labor costs.

Social Security outlook

Deficits: a trillion strong, and growing. According to the 1995 Social Security Trustees Report, OASI and DI deficits will build rapidly as the baby boom generation retires. The System's outlays will exceed tax receipts beginning in 2012, and it will begin to rely on its trust fund interest income to pay benefits. The Treasury will have to pay this interest out of general revenues (taxes) or increased federal borrowing. By 2020, OASDI outlays will exceed tax receipts and interest, and the Treasury will have to redeem the trust fund principal with general revenue or increased borrowing. Within 10 years, by early 2030, the $3.3 trillion trust fund will be exhausted, and the System will have to rely solely on its current tax revenue to pay benefits. The tax revenue will be inadequate to pay benefits on time, and checks will have to be increasingly delayed or reduced.

The deficits in the major entitlement programs ... will drive up the national debt, and the compounding debt will cause interest outlays to explode... Virtually all domestic saving would be required simply to service the federal deficit. Nothing would be left for maintaining or increasing the stock of capital.

In constant 1995 dollars, combined OASDI deficits will exceed $100 billion annually by 2020, $200 billion annually in 2030 after the last baby boomers finish retiring, and $400 billion annually by 2070. (See table.) In current dollars, with the Trustees' assumption of 4% inflation, the deficits will approach $8 trillion!)

Where the deficits come from. Americans are living longer and collecting greater benefits than ever before. Life expectancy at age 65 is expected to be 18.8 years when the baby boom has retired, compared to 12.6 years when the system was enacted, a 50% increase. The share of the U.S. population over age 65, just over 12 percent today, will climb to more than 20 percent when the baby boom has retired.

In constant 1995 dollars, combined OASDI deficits will exceed $100 billion annually by 2020, $200 billion annually in 2030 after the last baby boomers finish retiring, and $400 billion annually by 2070.

The rising numbers of elderly have already produced a sharp drop in the number of workers supporting each beneficiary, from more than five workers per retiree in 1960 to 3.3 workers in 1995. That number is expected to decline by more than a third, to two workers per beneficiary when the baby boom retires. Each working couple will be supporting a Social Security recipient.

The other source of the deficits is the Social Security benefit formula. The benefit formula is designed to keep benefits growing in line with income (constant "replacement rates"), no matter how much income grows over time. Per capita real income is projected to roughly double over the next 75 years. Consequently, per capita *real* benefits at the normal retirement age are also projected to roughly *double* under current benefit formula rules between 1995 and 2072. An average wage married worker retiring at age 65 in 1995 received over $15,000 (with the 50% "spousal benefit"); a similar couple retiring in 2072 is projected to receive over $30,300 in 1995 dollars. A high income two worker couple could have received over $28,800 in benefits in 1995; a similar couple is projected to receive $64,000 in 2072 in 1995 dollars.

People who have tried repeatedly to patch up the system are repeatedly surprised that it keeps slipping back into deficit, but there is no mystery as to why. It is not possible to pay rising real benefits for a rising number of years of retirement with a declining number of workers per beneficiary without continual tax rate increases. Each payroll tax increase discourages employment, saving, and income, further weakening the system. Every effort to patch up the system merely reinforces the adverse demographic trends that render the system unrepairable.

> ***People will need adequate warning and adequate time to adjust to changes in Social Security... The sooner Congress addresses the issue, the better.***

People are young before they are old. It makes no sense to lower their after-tax incomes, employment opportunities, and ability to save while they are of working age in order to give them higher transfer payments after they retire. A better way must be found to enable people to provide for themselves in their old age. Fortunately, there is such a way: old-fashioned thrift. Future papers in this series will explore that alternative.

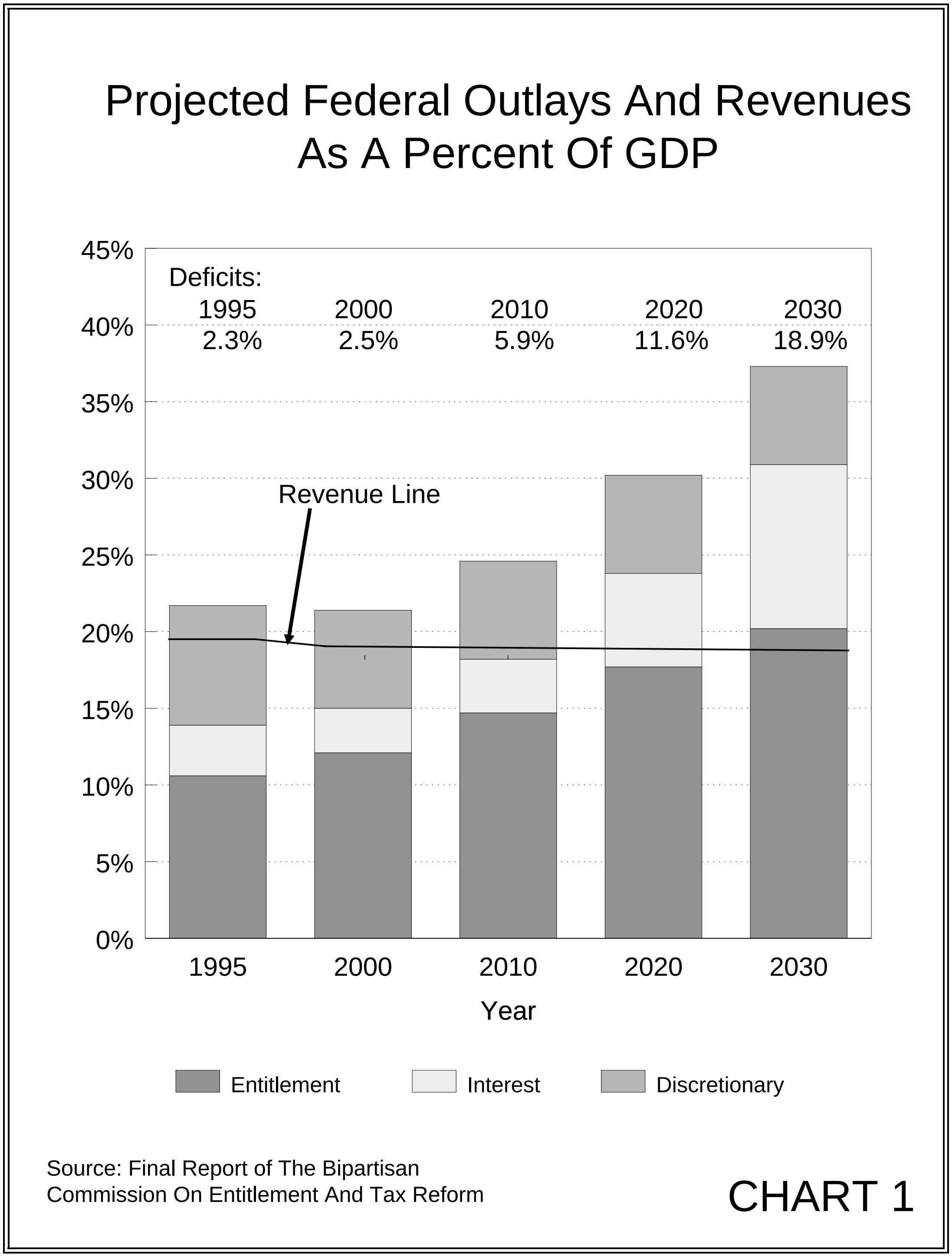
However the pending bankruptcy of Social Security is addressed, people will need to save more for their retirement than they are doing today. It takes time to accumulate saving. People will need adequate warning and adequate time to adjust to changes in Social Security. The worst thing Congress could do is to pretend that there is no problem and wait until the checks are late to begin thinking about changing the system. The sooner Congress addresses the issue, the better.

Stephen Entin
Resident Scholar

Table 1. Old Age, Survivors, and Disability Insurance Surpluses and Deficits (-) Excluding Interest

calendar year	current dollars (billions)	1995 dollars (billions)	percent of OASDI taxable payroll*	percent of GDP
1995	$29	$29	1.09	0.41
2010	25	14	0.42	0.16
2015	-57	-27	-0.63	-0.27
2020	-232	-109	-2.09	-0.84
2030	-766	-200	-4.19	-1.64
2050	-2,242	-267	-4.45	-1.67
2070	-7,745	-421	-5.71	-2.06

Source: 1995 Social Security Trustees Report, tables IIIA.2, III.B.1, III.B.4, and III.C.1, intermediate assumptions. Current dollars converted to 1995 dollars using projected CPI.
**OASDI taxable payroll is $62,700 (maximum, per worker) in 1996.*



Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.