IRET Congressional Advisory

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DEALING WITH SOCIAL SECURITY DEFICITS: LIMITED CHOICES, UNLIMITED OPPORTUNITY

This advisory is the second in a series on the outlook for Social Security's retirement and disability programs (Old Age and Survivors Insurance and Disability Insurance — OASDI). The first advisory reported on the large deficits projected for the system (based on then-available numbers in the 1995 Trustees Report). That advisory explained how demographic changes and the ever-increasing per capita real benefits promised under current law will lead the system into inevitable bankruptcy and/or wreck the federal budget.

Simply raising payroll tax rates to patch up OASDI and HI is not the answer. It would devastate employment. Ultimately, as many as 10 million jobs could be lost.

1996 Trustees Report — same bad news

The new 1996 Trustees Report, released in June, shows very little change from the 1995 projections. The retirement system is projected to begin running operating deficits — benefit payments in excess of tax revenue — in 2012, a year earlier than assumed in the previous report. The program is assumed to exhaust its trust fund in 2029, a year earlier than previously projected. The very long term deficits are projected to be very slightly lower than assumed in the last report due to minor revisions in economic and population assumptions. By the end of the forecast period, 2070, OASDI deficits will exceed $400 billion dollars per year in inflation-adjusted 1996 dollars, equal to 5.5% of taxable payroll or nearly 2% of GDP. (See table.) Even worse, if Medicare (Part A, Hospital Insurance — HI) is factored in, the combined OASDI and HI deficits eventually approach $1.17 trillion annually, in real 1996 dollars, almost 14% of taxable payroll and over 5.5% of GDP (not shown).

Limited options for dealing with the deficit

There are very few options for dealing with the OASDI deficits, and they have very different economic impacts.

Options for patching up the existing social security system are very limited. They consist of raising the payroll tax rate sharply, massive federal borrowing, or freezing real benefits. These options are either bad for the economy and people when they are of working age, or bad for people when they reach retirement age.

The only alternative that could create all winners and no losers is to replace the system, in part or, better, in whole, with a program of real private saving.

Raise payroll taxes

Simply raising payroll tax rates to patch up OASDI and HI is not the answer. It would devastate employment. Ultimately, as many as 10 million jobs could be lost.

The current payroll tax is 15.3 percent, half paid by the worker and half paid by the employer. Of that total, 10.6 percent is permanently allocated to retirement and survivors benefits, 1.8 percent to disability insurance, and 2.9 to HI.[1]

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Just to balance OASDI would require steady increases in the payroll tax bite on wages reaching 4 percentage points by 2030 and 5.5 percentage points by 2070. The tax hikes would have to be absorbed by employers and workers. In part, the tax would raise labor costs. Businesses would be forced to cut back production and employ fewer workers. In part, the tax increase would depress hourly take home pay, reducing the number of workers willing to work at a given pre-tax wage.

We estimate that a 5.5 percentage point increase in the payroll tax would depress employment by roughly 2 to 3 percent below levels that are now projected, equivalent to about 2.5 to 3.5 million jobs in today' s economy, and 3.5 to 4 million jobs in the larger labor force of the next century. The tax hikes needed to balance HI as well — over 9 percentage points by 2030 and 14 percentage points by 2070 — would ultimately bring the total payroll tax to about 29.3 percent and do two to three times the damage to employment. In either case, the damage to the economy would feed back onto the Social Security system, requiring even larger tax increases than the projected deficits indicate.

Even if the increase in the payroll tax were stretched out over many years, it would permanently and substantially reduce the level of employment and output. To put an additional 5.5 percent tax on wages in to perspective, consider that labor productivity and wages have been struggling to grow at even 1 percent per year in recent times. The tax hike would steal away 5.5 years of gains in real after-tax labor income.

Alternatively, consider that wages are the overwhelming cost item for many small, labor intensive businesses, such as restaurants. Such businesses may have a gross margin on sales of 3 percent or less. A 5.5 percent tax increase in the wage bill might exceed that margin by nearly 200 percent. Businesses would have no choice but to demand that workers accept a lower wage or reduced benefits. If compensation levels in such businesses are not significantly above the minimum wage, however, there may be no room for such a reduction. The result would be the closing of many businesses and the "down-sizing" of many more.

If the OASDI or HI deficits were covered by federal borrowing, the ... compounding debt would cause interest outlays and budget deficits to explode. As noted in the previous advisory, Federal deficits would exceed national saving by the time the baby boom finished retiring. There would be no domestic saving left to replace the stock of capital as it wore out, let alone expand it.

As this last example indicates, the impact of the payroll tax increase would be different across industries. It would be particularly onerous on labor intensive industries, such as services and trade, and less damaging to capital intensive industries, such as manufacturing. Nonetheless, especially in a competitive world economy, it would result in the downsizing of the U.S. economy as a whole.

The payroll tax is already larger than the income tax for the majority of American families, and is destroying their ability to save for a home, a college education, and retirement. Further increases in the payroll tax are flatly unacceptable.

Borrow from the public

The OASDI deficit will reach 1.5% of GDP by 2030 and almost 2% of GDP by 2070. The combined OASDI and HI deficits will approach 4% of GDP by 2030 and exceed 5.5% by 2070. Thus, deficits in these two programs alone would be two to three times greater, as a share of GDP, than the current total federal budget deficit. Even in the larger economy expected late in the next century, and even if the rest of the budget were initially in balance, the OASDI and HI deficits would represent a large part of the economy and a large part of national saving.

If the OASDI or HI deficits were covered by federal borrowing, the national debt would increase, and annual interest outlays would increase accordingly. The compounding debt would cause interest outlays and budget deficits to explode. As noted in the previous advisory, Federal deficits would exceed national saving by the time the baby boom finished retiring. There would be no domestic saving left to replace the stock of capital as it wore out, let alone expand it. The economy would be forced to contract, or become entirely dependent on highly unlikely ever-increasing foreign capital inflows for its growth.

Use of the OASDI trust funds would not avoid this damaging deficit finance; it would exacerbate it. The trust funds are not a means of paying benefits. Treasury must pay benefits from current taxes or borrowing whenever benefits are due.

The trust fund balances are in fact simply bookkeeping entries at the Treasury, containing Treasury securities, Federal I.O.U.s. These are liabilities, not assets, of the government. They represent past years' excesses of payroll taxes over benefits. That excess payroll tax revenue was "borrowed" from the trust funds and used to pay for other government programs in order to hold down borrowing from the credit markets when the rest of the budget was in deficit. Similarly, the Treasury's payment of interest to the trust funds was similarly "borrowed" back. Consequently, in 2012 and beyond, as the baby boom retires and the time comes to pay future retirement benefits out of interest or principal in the trust funds, the Treasury will have to use the taxes it is then receiving or borrow additional money in the credit market.

Massive government borrowing from the public would drain private saving and retard investment and growth. To avoid that outcome, large borrowing requirements have, historically, put enormous pressure on governments to resort to inflation financing. The projected deficits in Social Security would dwarf any previous federal deficits in magnitude and duration. If the government were to resort to inflation finance, it would have serious consequences for retirees, workers, home buyers, and businesses, much as it did in the inflationary periods between 1973 and 1981.

Trimming benefits would make social security an extremely bad deal for most future workers and retirees... Some might just as well have stuffed their money under the mattress.

Trim benefits

The social security system could almost squeeze through the retirement of the baby boom generation if future real benefits were about frozen at today's levels or reduced slightly in real terms through a combination of benefit formula changes and increases in the normal retirement age. Trimming benefits would make social security an extremely bad deal for most future workers and retirees.

Most of the workers who retired in the late 1970s or early 1980s before the major run-up in the payroll tax rate following the 1977 Social Security Amendments got a relatively good deal from the system. They paid a low tax rate while they worked. They got back what they paid in, plus reasonable interest, within a few years of retirement, and the rest was gravy. More recent retirees faced the current high payroll tax rates throughout some of their working lives, and some have had to pay tax on a portion of their benefits. These retirees got less of a deal, but probably a positive rate of return on their "contribution".

The further into the future one is going to retire, however, the worse the deal will get. Future generations of retirees will have faced the current

Table 1. Old Age, Survivors, and Disability Insurance Surpluses and Deficits (-), Excluding Interest				
Calendar Year	Current Dollars (billions)	1996 Dollars (billions)	Percent of OASDI Taxable Payroll*	Percent of GDP
1996	$32	$32	0.98	0.42
2010	17	10	0.29	0.10
2015	-56	-56	-0.66	-0.26
2020	-216	-87	-2.02	-0.78
2030	-703	-191	-3.98	-1.50
2050	-2,093	-259	-4.30	-1.56
2070	-7,230	-409	-5.51	-1.93

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

tax rates for greater portions — ultimately all — of their working lives, and more of them will be subject to benefit taxation over time because the income thresholds for taxation of benefits are not indexed for income growth or inflation. Future retirees will find social security to be a steadily worsening deal even if the rising benefits promised under current law could somehow be paid. But they cannot be paid unless tax rates are increased, making the deal that much worse. If, instead, the benefits are frozen at current levels, the deal will also worsen. Some future retirees, especially those who had been single workers with above-average lifetime earnings, or working spouses, will get back a below market return, or less than the present value of their contributions. Some might just as well have stuffed their money under the mattress.

The only alternative that could create all winners and no losers is to replace the system, in part or, better, in whole, with a program of real private saving... Workers should be allowed to divert a portion of their payroll tax into private saving in exchange for reduced or even eliminated benefits.

Clearly, there is no way to make the current system good for future workers/retirees. Any steps taken to restore balance within the confines of the current system will make a bad situation worse. To have a net gain, one must think "outside the box".

Convert the system into real private saving

"Outside the box" means returning to real private saving. Workers should be allowed to divert a portion of their payroll tax into private saving in exchange for reduced or even eliminated benefits. The higher returns available in the private sector on real, fully-funded saving could provide a higher level of retirement income than the current tax-transfer system can hope to sustain. Future retirees would come out ahead even if a portion of the payroll tax were retained for a period to continue paying benefits to current or soon-to-be retirees.

Future Advisories will discuss the potential benefits of letting people save for their own retirement, review various proposals to "privatize" Social Security, and discuss the most difficult question, how to pay for the transition.

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Endnote

1. These tax rates are those for the year 2000 and beyond. Currently, the OASI tax rate is 10.5 percent, and the DI tax rate is 1.9 percent. Part of the OASI tax rate has been temporarily reallocated to DI to tide DI over a supposedly temporary rough patch. There is no sign, however, that DI eligibility rules are going to be tightened enough in the next 4 years to contain DI's recent utilization and cost explosion, and allow the rates to revert to their statutory pattern.