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Social Security Spin

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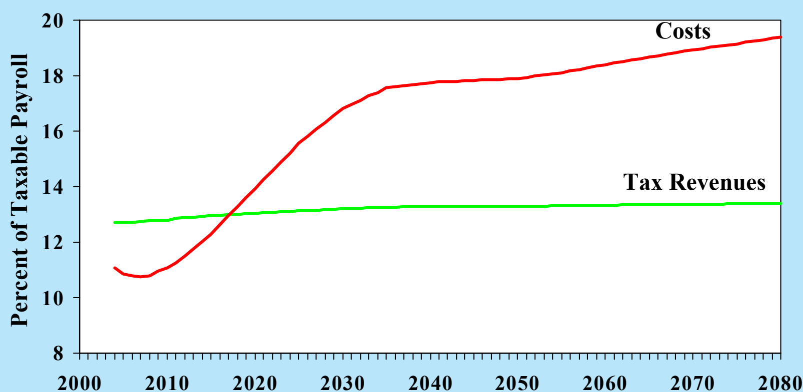
Judging by the recent rush of media attention and statements from the White House, it appears the long awaited reform of Social Security will occur during the upcoming Congress. What form that reform will take is anybody's guess. As members of the media report on the debate, several themes are repeated in their stories. Two topics receive frequent mention because the president has in mind a reform which includes personal retirement accounts. One is the cost of the transition and the other is possible benefit cuts for future retirees. We will discuss each of these topics in turn. Along the way, we will see that all potential reformers must face the same fundamental problem and must weigh the same fundamental tradeoff.

The Problem

The fundamental problem facing Social Security is summarized in the accompanying graph. Most of those familiar with Social Security know that its costs, in the form of benefit payments, will exceed its dedicated tax revenues beginning in 2018. The gap between cost and revenues grows in every year thereafter as the graph clearly shows. The present value of the difference between projected costs and revenues is $10.4 trillion. Closing this financing gap is the task of all reformers.

Before we go any further, we must note that some analysts do not think this graph correctly summarizes the problem. They argue that the system is sound until the Trust Fund is exhausted in 2042. They are absolutely correct in asserting that the Trust Fund will last until 2042. However, drawing on the Trust Fund is a classic example of "robbing Peter to pay Paul," for it implies capturing revenues from elsewhere in the budget by reducing other spending, increasing other taxes, or increasing borrowing beginning in 2018 and continuing until 2042. So while the Trust Fund lasts until 2042, in the context of the budget as a whole, the Trust Fund provides no new revenues.

As can be seen from the graph, the system is in surplus today, as it has been since the 1983 reforms. These surpluses have been credited to the Social Security Trust Fund which now stands at over $1.5 trillion, but ever since the 1983 reforms, the Social Security surpluses have been spent elsewhere in the Federal budget. For the past 20 years we have been doing the reverse of what will begin in 2018 and beyond. We have been robbing Social Security to pay for other programs. The bottom line is that the Trust Fund will provide no new revenues when Social Security needs them to close its funding gap. So how does one close this gap?



Source: 2004 Trustees Report (OASDI), Table IV. B1.

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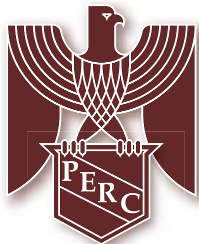

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The Tradeoff

This is where the answers are as numerous as there are members of Congress. The gap can be closed by raising future taxes to match the costs depicted in the figure. It can be closed by cutting benefits to the level that can be funded by the current tax rate. It can be closed by a combination of raising taxes and reducing benefits, of which there are countless permutations. Tweaks in the system such as increasing the taxable maximum, reducing benefit indexation, change the benefit formula, increasing the retirement age, and reducing benefits for higher earners represent some of the ways to close the funding gap.

More fundamental reforms close the gap by moving away from the current framework of taxing one group(workers) to pay another group(retirees). These reforms involve increasing savings today to prepay benefits tomorrow. But like tweaking the current framework, such reforms are many.

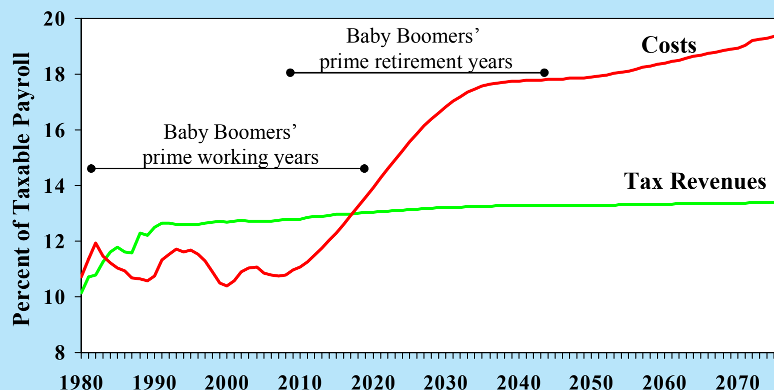
Regardless of the reform, each implies a fundamental tradeoff between generations. To illustrate the tradeoff, the accompanying graph shows the Baby Boomers' prime working years, between 35 and 55 years of age, and prime retirement years, between 62 and 80 years of age. These years are shown along with the Social Security program's cost and revenues as a percent of taxable payroll.

Consider the option of paying the costs as scheduled. This option imposes the burden of paying future benefits squarely on the shoulders of future workers and taxpayers. The Baby Boomers pay a tax rate of about 12 percent during their working lives, while future workers must ultimately pay the 18 percent cost rate.

Now consider scaling back future benefits to the level that can be sustained assuming the tax rate does not change. This means that the Baby Boomers will receive only the benefits that can be supported by the current tax rate, but these benefits are ultimately 25 percent less than those scheduled. Such a reform results in the Baby Boomers bearing the brunt of the cost. The next generation of workers would pay the same tax rate as the Baby Boomers pay and receive comparable benefits, though these benefits are scaled back relative to the benefits the current generation of retirees is receiving.

A reform that cuts benefits and increases taxes to balance the system's finances results in the Baby Boomers receiving lower benefits than those that are scheduled and future workers paying higher taxes. Thus, both generations bear part of the burden of the reform.

Do the prepayment alternatives have different generational burdens? The answer depends on the extent to which benefits are truely prepaid. Suppose we start today with a program which prepays some or all future scheduled benefits. Prepayment of benefits requires additional resources from current workers. As the graph shows, the Baby Boomers, as a group, have about 15 years remaining of their prime working years. The additional resources from the Baby Boomers would come in the form of contributions to personal retirement accounts, and thus, they would bear some of the costs of the reform.



The greater the extent to which benefits are prepaid, the greater is the reduction in the burden borne by future workers.

Note however, that if the accounts are funded through additional borrowing rather than additional savings, then future workers must pay off the additional debt, and we are back to a situation that is similar to simply paying the cost rate and the associated generational burdens.

Transition Costs

The previous discussion provides the backdrop for understanding transition costs. Recent media reports have stated that the transition costs of the personal retirement accounts reform, favored by the president, amount to between $1 and $2 trillion. What exactly do these estimates quantify? Do transition costs quantify the costs of shifting from the current financing arrangement to a partially prepaid system? As we will see, prepayment and paying scheduled benefits with future tax revenues have the same costs. An example will illustrate.

Suppose you have a $200,000 mortgage that has a series of monthly payments for the next 30 years. If you decide to step up your payments so as to retire the note sooner, is there a transition cost to doing so? For simplicity, assume that the rate you can receive on any savings is exactly the same rate as your mortgage rate. Well, you would have to consume less now to make the higher payments, but in the future you will be able to consume more than you would if you were still making the monthly payment. Thus, you have just changed the timing of the financial burden. Regardless of the option you take, you have to pay the $200,000 mortgage.

Similarly, prepaying Social Security partially or totally simply changes the timing of the financial burden and thus changes the generational burden of the program. However, if the goal of the reform is to pay scheduled benefits as depicted in the graphs, then the present value of those scheduled benefits are the basic costs of the program. The current financing arrangement cannot pay these costs and so the system must be reformed, but the costs are the same for all reforms. As pointed out above, the distinguishing characteristic of the reforms are the way in which they distribute the burden of the program across generations.

Benefit Cuts

Another misleading criticism of Social Security reforms which include personal retirement accounts is the claim that they involve benefit cuts. Such claims result from either a misunderstanding of how prepayment works or scare tactics. Personal retirement accounts provide a means by which individuals partially or totally prepay the benefits they are scheduled to receive from Social Security. Personal retirement account reforms are typically coupled with a pre-announced reduction in the defined benefits that will be paid by the Social Security Administration.

With a personal retirement account reform, workers save more and accumulate a fund from which they will purchase an annuity. The goal of most reforms is for the sum of the annuity and the reformed defined benefits to equal the benefits that are currently scheduled. Thus, the reforms do not reduce the total combined benefits retirees will receive. However, the reforms do reduce the share of total benefits that will be paid by future taxpayers, and as a result, future taxpayers have a lower burden than they would if all benefits had to be paid for through contemporaneous tax payments.

All Social Security reforms must deal with the fact that benefits, as currently scheduled, cannot be paid for with the current tax rate. Comparing the reforms boils down to identifying how different generations will be affected. In addition to reducing the burden on future generations, prepayment with personal retirement accounts has two other collateral benefits. Workers become the owners of their retirement accounts, and increased savings will increase the nation's income relative to the current financing arrangement. For these reasons, such reforms offer a promising alternative in the current policy discussion.