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SOCIAL SECURITY SHORTFALL LONG WAY OFF

Improved long-term outlook makes privatization push even less relevant

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The latest release of the Social Security trustees' report shows—once again—that Social Security is safe for at least another generation, and that, despite the current recession, its future outlook is steadily improving. The trustees revised upward by three years, to 2041, the period over which Social Security is expected to pay full benefits. After this date, Social Security's income is still expected to pay for more than two-thirds of benefits. The projected shortfall can be covered by making small changes in the way the system is financed.

The alternative to small financing adjustments—dismantling Social Security through privatization—is not a workable solution because it would require large transfers from the government and substantial benefit cuts. Under the privatization options proposed by the President's Commission to Strengthen Social Security, the trust fund would either be exhausted in 2027, or promised benefits for today's 35-year-olds would have to be cut by as much as 18%. Moreover, Social Security would still require $3-5 trillion, in today's dollars, to close anticipated financing gaps.

All exhaustion dates extended

The 2002 report extended all of the anticipated exhaustion dates for Social Security revenue. The income of the trust fund is now expected to fall short of promised benefits in 2017, compared to 2016 in last year's projections. Total income—tax revenue and interest income—will be less than expenditures in 2027 (as compared to 2025 in the 2001 report), and trust fund assets will be depleted in 2041 (compared to 2038 in the 2001 report). Once the trust fund is depleted, tax revenues are still projected to cover two thirds of benefits through 2075.

The unworkable alternative of private accounts

The anticipated financing shortfall for Social Security after 2041 rests on pessimistic economic assumptions, which are proving to be incorrect year after year. In particular, productivity growth has proven to be stronger than expected and thus has helped to continuously improve the future outlook for Social Security (Rasell and Weller 2001). But even if these pessimistic assumptions should prove to be correct in the long run, minor fixes to Social Security can cover the projected financing gap. Unworkable, and too costly, is the proposed alternative of dismantling Social Security by creating individual accounts (Weller 2001a). The three individual account options proposed by the President's Commission to Strengthen Social Security in December 2001 clearly illustrate why privatization options are too costly to consider seriously.

Under the commission's first option, each worker can voluntarily contribute 2% of payroll that would have gone to Social Security to an individual account. In exchange, a worker would have to give up "the amount of benefits those payroll taxes (with interest) would have bought from Social Security." Each dollar contributed to an individual account would be replaced by a fixed-dollar reduction in benefits to that individual. If Social Security had to shoulder the transition costs of this proposal and if everybody participated, the trust fund would be exhausted in 2027 (SSA 2002).

Under the commission's second option, each worker can choose to contribute 4% of payroll otherwise earmarked for Social Security to an individual account up to a wage-indexed maximum of $1,000. As in the first option, Social Security benefits would be cut in line with the worker's contribution. Additionally, benefits would be cut across-the-board, regardless of individual account contribution, by indexing them to the rate of inflation rather than the generally higher rate of average wage growth. For some workers, the plan would compensate for part of this benefit cut by raising benefits for low lifetime earners and surviving spouses.

This switch in the indexation of benefits from the rate of average wage growth to the rate of inflation is a relatively obscure technical change that has large implications, especially for younger workers (Weller 2001b). It would mean that Social Security benefits will stay fixed in real terms forever, never to increase in step with future improvements in living standards. Because wages generally grow faster than inflation, living standards tend to rise from generation to generation. For an average earner who is 35-years-old in 2002, this switch would mean a cut in promised benefits by 18.2%, regardless of whether the earner decides to invest in individual accounts. In other words, Social Security benefits will continuously decline for anyone retiring after the year in which the change takes effect (presumably 2009). If this indexation method had been a feature of Social Security since its inception, today's retirees would receive a benefit linked to a basic living standard set in 1935, when a large share of households did not even have indoor plumbing.

Under the third option proposed by the commission, workers could decide to contribute 1.0% of their own money to individual accounts, and their contribution would be matched by 2.5% from payroll taxes that otherwise would have gone to Social Security. Social Security benefits would be offset, as in the first two proposals. But this third proposal would lower benefits in line with improvements in longevity, "by an amount equivalent to increasing the normal retirement age," and reduce early retirement benefits (SSA 2002). Benefits would be reduced for high lifetime earners, but raised for low lifetime earners and surviving spouses.

Cutting benefits to compensate for the longer life span over which benefits are paid out means that workers will have to work longer to get the same benefit as previous generations. To compensate for the higher normal retirement age, workers could either work longer or else try to save more. However, for the many workers with poor health, continued work is not an option. This is especially true for workers in physically demanding jobs, low-wage workers, and African Americans. These workers could still retire early, but only with severely reduced benefits. Moreover, most of the groups of older workers whose declining health prevents them from working longer are the same workers who lack adequate savings (Weller 2001c). As a result, a large minority of older workers will have to retire with reduced benefits, while others may be forced to continue working despite their poor or rapidly declining health.

The changes that the President's commission proposed for retirement benefits will also bring about reductions in disability and survivorship benefits. Social Security is a social insurance program that offers workers and their families wage insurance in case they lose their main source of income due to a worker's retirement, disability, or death. About one-third of Social Security's payments go to recipients of disability and survivorship benefits; in 2000 these recipients included 3.3 million children (Weller and Bragg 2001). Because the disability and survivorship benefit formulas are connected to the way in which retirement benefit cuts are calculated, benefits under both programs will be cut if retirement benefits are reduced. This cut will especially hurt African Americans, who depend disproportionately on disability benefits, and women, who depend more than men do on survivorship benefits.

Common to all three proposals by the President's commission is that they would require large transfers from the government to Social Security to even maintain the program's currently projected finances—in addition to the severe benefit cuts that are proposed. Assuming that two-thirds of workers choose to contribute to individual accounts, the total gross shortfall over the next 75 years, expressed as net present value, would be $5.3 trillion, $2.8 trillion, and $3.4 trillion for options I, II, and III, respectively (SSA 2002). Put another way, although options II and III reduce benefits for everybody dramatically, and although these options lower the insurance value of Social Security substantially, privatization is not able to bring Social Security into balance.

Rather than reducing benefits, which would leave millions of workers without adequate retirement income, proposals to address the shortfall should include options for generating new revenues. For instance, the arbitrary cap above which earnings are exempt from the Social Security payroll tax could be raised or eliminated, a method for increasing revenue that has even found some support within the commission (Kirchhoff 2001). The complete elimination of the cap—currently at $84,900—would affect fewer than 7% of wage earners, but it would cover more than three-quarters of the expected shortfall. Before policy makers pursue the kinds of draconian steps laid out by the commission, they should give serious consideration to the simpler and fairer reform of removing this cap.

This year's trustees report shows that Social Security is sound and its future is getting brighter. Even the trustees' less optimistic projections show the program will pay full benefits for 39 years, and will have funds for two-thirds of benefits in 2075 without any changes being made. Thus, drastic steps, such as risky privatization proposals, are unwarranted, beneficial to only the luckiest few, and harmful to the majority of America's retirees.

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