What You Need to Know About Social Security

By
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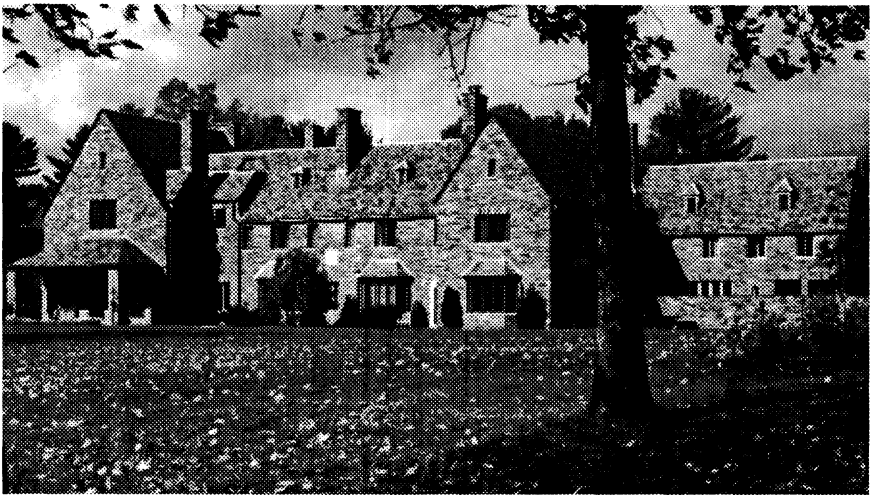

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INTRODUCTION

THE Federal program officially titled Old-Age, Survivors, and Disability Insurance, or OASDI, better known as Social Security, seeks to prevent poverty resulting from old age, retirement, the death of an income-earning spouse or parent, or disability.

About 96 percent of the labor force pays taxes on labor income to finance Social Security's benefits to retired workers, their survivors, and disabled Americans. Both the Social Security tax rate and the maximum amount of income subject to the tax have risen to substantial levels, and for a great many taxpayers, Social Security taxes take more of their earnings than does income taxes.

Roughly 90 percent of Americans aged 65 and above receive Social Security benefits, and for many of them, such benefits are their major, or even their only, source of retirement income. Social Security survivors' benefits and disability benefits are also important income sources for many persons.

Thus, Social Security figures importantly in the lives of almost all Americans, and the outlook for Social Security is a major national concern. Within the next 20 years, it is virtually certain that because of increased life expectancy and the retirement of the large "baby boom" generation born between 1945 and 1965 (the latter will have to be supported by the smaller generations born after 1965), the Social Security system's outlays will begin to exceed revenues by an ever increasing margin.

In the next few years, therefore, America will need to make major decisions about Social Security. These decisions will affect you in important ways: your tax bill; how much you will receive in Social Security benefits; and when you will retire—if you will be able to retire while maintaining an acceptable standard through your old age.

While critical examinations of Social Security are now proliferating, the American Institute for Economic Research can proudly claim the title of pioneer. We gave Social Security critical scrutiny from its very beginning. In August 1935, the same month in which Social Security became law, AIER pointed out the depressive effects Social Security's taxes were likely to have on savings and capital and the program's apparent unconstitutionality. In January 1939, when the first major amendment, and liberalization, of Social Security was proposed, the Institute warned presciently that Social Security "will burden the present younger generation, and those to come, far more than is generally understood," and that that burden "may be

greater than can be undertaken without serious damage to our economic system."[1]

The Institute's founder, E. C. Harwood, was perhaps the harshest critic in print of Social Security from the 1930s until he died in 1980. He labeled Social Security a Ponzi scheme, pure and simple, and ranked it among the three greatest swindles perpetrated by government in human history[2]—a fraud that not only burdened younger and future generations in order to enrich current retirees, but also retarded capital formation, employment, and, most important, individual initiative and responsibility. Its combined effects over the long term, he noted, could be expected not to promote, but to curtail, improvements in standards of living.

AIER has since examined many aspects of Social Security, e.g., the retirement earnings test; anomalies of benefit calculation; the Social Security trust fund and its role in Federal budget accounting; and the putative "returns" on Social Security taxes compared to what one could earn investing the same sums in private instruments. Harwood also recognized that the consequences of unwinding such massive frauds as Social Security are never painless and often create new opportunities for even greater mischief. With this in mind, AIER has addressed the vexing question of what to do about Social Security, taking a hard look at various reform proposals and offering solutions of its own.

Social Security is very important both in our national life and in the lives of individuals. It is vital that you have a clear understanding of what Social Security is and what it is not; how it developed; its myths and realities; the nature of its coming crisis; the options for Social Security reform; and how Social Security's crisis is likely to affect you. This book seeks to meet that need.

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[1] American Institute for Economic Research, *Monthly Bulletin,* August 1935, and "Whither Social Security?," in American Institute for Economic Research, *Weekly Bulletin,* January 23, 1939.

[2] The other two he named were monetary inflation, which robbed the thrifty of their savings, and the establishment of the Securities and Exchange Commission, which gave investors unwarranted confidence in new, untested, securities.

I.

A BRIEF HISTORY OF SOCIAL SECURITY

STATE-ADMINISTERED "social insurance" financed by taxes on payrolls originated in Germany under Otto von Bismarck. He believed that measures such as his Sickness Insurance Law (1883), Accident Insurance Law (1884), and Old Age and Disability Insurance Law (1889) would make German industrial workers less receptive to socialism. Other European countries followed with similar programs, most notably Great Britain's National Insurance Act (1911), which provided compulsory sickness and unemployment insurance.

In the United States prior to the 1930s, family members and private charities (as well as limited government relief) provided care for the elderly, the disabled, and the unemployed. Numerous intellectuals in the latter half of the nineteenth century and early twentieth century agitated for government action to relieve these and other hardships. Some states enacted social insurance programs providing unemployment and old-age benefits, but many academics, labor unions, social workers, and social insurance advocates such as Isaac Rubinow and Abraham Epstein agitated for national social insurance, citing the European precedents.

They made little headway until the Great Depression, when unemployment was very high among the elderly as well as the young. Declining birth rates led to smaller families that were less capable of caring for their own. Moreover, many Americans who prudently had accumulated assets for their old age were wiped out by the Crash, bank failures and bankruptcies. By the end of 1934 some 750,000 elderly Americans were on Federal relief. Many private charities and pension plans were collapsing for want of funds. Want of revenues crippled mandatory pension laws passed by states in response to the plight of the aged.

As governor of New York, Franklin Roosevelt had repeatedly sought enactment of old-age insurance financed by "premiums" paid by young workers, employers, and the state government. He proposed old-age insurance during the 1932 presidential campaign. In 1933, President Roosevelt tried hard to promote social insurance to his administration, the Congress, and the country. In 1934 he created a Committee on Economic Security and panels of expert advisers to develop an economic security program of social insurance to propose to Congress.

Meanwhile, agitation was boiling on the political left for radical changes in how America provided for the aged. Most importantly, the famous

Townsend Movement began in 1933, when a California physician, Dr. Francis Townsend, propounded a plan to relieve old-age poverty by paying every American aged 60 and over a monthly $200 pension, financed by a "revolving pension fund" of sales tax revenues, on the condition that the beneficiary retire and spend the pension within a month of receiving it.

The Townsend Plan had enormous appeal to the elderly, and a nationwide movement, with millions of members, arose to promote it and pressure Congress to enact it. Roosevelt warned his Committee on Economic Security that any proposal had to include old-age insurance to enable Congress and the administration to withstand the pressure of the Townsendites. Some scholars argue that Social Security was a response to the Townsend Movement. While the Movement did weaken congressional resistance to the administration's proposals, it probably simply expedited enactment of a program that Roosevelt already wanted.

The Social Security Act of 1935

Introduced in Congress on January 17, 1935, the administration's economic security bill was a comprehensive package of measures: old-age assistance for poor persons who were already elderly and hence could not draw benefits under social insurance because eligibility was based on previous employment in covered occupations; aid to families with dependent children; maternal and child health care, especially for persons in rural and distressed areas; unemployment insurance; and the old-age program, Social Security. Interestingly, the original bill also contained a provision for voluntary purchase of annuities from the government, which was deleted.

There were other changes as well. Treasury Secretary Henry Morgenthau, with Roosevelt's approval, insisted that tax rates be raised enough to create a large reserve fund, projected to reach $50 billion by 1980, to help defray future expenses. Also, the bill was purged of insurance language, because the administration and its allies in Congress feared that the Supreme Court would invalidate a government program of compulsory, tax-funded old-age insurance.

Roosevelt signed the Social Security Act into law on August 14, 1935. Titles II and VIII contained Social Security's benefit and tax provisions. Title VIII, Taxes with Respect to Employment, levied taxes on wages received after December 31, 1936, in employment other than agricultural labor, domestic service, casual labor outside one's line of work, employment in state or local government, work on a vessel, or employment in a nonprofit organization. The tax rate for calendar 1937-1939 was one percent; it would be 1.5 percent for 1940-1942; 2 percent in 1943-1945; 2.5 percent in 1946-1948; and three percent thereafter. Employers would pay

matching taxes. The maximum annual income subject to the tax was $3,000.

Title II, Federal Old-Age Benefits, created an "Old-Age Reserve Account" at the Treasury. Every fiscal year, funds deemed sufficient to pay benefits were to be appropriated to the Account by Congress. Amounts appropriated but not needed for current benefit outlays were required to be invested in interest-bearing U.S. government debt, including special unmarketable debt created for this purpose and earning three percent a year, and debt whose principal and interest were guaranteed by the government.

Monthly benefit payments were to begin on January 1, 1942, to qualified individuals—that is, persons who were at least 65 years old who had been paid wages for employment on at least five days between December 31, 1936 and their 65th birthday, and who had earned at least $2,000 in that period, in occupations other than the exceptions mentioned above. However, another provision, which became known as the "retirement earnings test," stipulated that the beneficiary had to be retired in order to collect benefits; he would lose his entire benefit for every month in which he received wages from employment covered by the Act. Benefits were based on earnings during the period from the end of 1936 to one's 65th birthday. The smallest monthly benefit was $15, the largest $85.

If the beneficiary died before turning 65, his estate would receive a lump sum equal to 3.5 percent of his wage income since the end of 1936. If he turned 65, began collecting monthly benefits, and then died, his estate would get a lump sum large enough to raise his total benefits to 3.5 percent of his wage earnings since the end of 1936. If an individual had worked in an occupation covered by the Act and had turned 65 without qualifying for monthly benefits, he would get a lump sum equal to 3.5 percent of his wage earnings since 1936. In short, the original Act provided that the worker—or his estate—would always receive at least as much as he had paid in: a money-back guarantee.

There were some telling omissions. The Act said nothing about contracts, insurance, rights, or guarantees. And the Act said nothing about the money in the Account belonging to the workers who had paid it, or a trust fund holding their money for them, or about their money being held in individual accounts.

Title VII created a three-member Social Security Board to head the administration of Social Security and report regularly to Congress on how the program was being run. The Act included, in Title XI, General Provisions, a "reservation of power" clause, Section 1104: "The right to alter, amend, or repeal any provision of this Act is hereby reserved to the Congress." Such reservation of power is routine in acts of Congress, but it

carries momentous implications, given the way Social Security has been presented to the public, the public's understanding of the program, and the realities of the Social Security system.

Although the Act contained no insurance or rights language, the Roosevelt administration began describing Social Security as "annuities" or "insurance" paying benefits "as a matter of right."[3] In this it was seconded by newspapers and magazines, and by Democratic politicians, including President Roosevelt himself.

On May 24, 1937, in the *Helvering v. Davis* decision, the Supreme Court voted 7-2 to find Social Security constitutional, probably to fend off Roosevelt's proposal to pack the Court, which Congress was considering at that time. *Helvering v. Davis* cleared the way for Social Security's administrators to resume marketing the program as insurance. Social Security literature explaining the program to the public was rewritten to insert insurance language.

The 1939 Amendments

In 1939, the Social Security Act was substantially amended. These changes had far-reaching consequences for both the public's perception of Social Security and for its realities.

Pressure was rising for liberalization of Social Security. An influential article by insurance executive Reinhard Hohaus argued that Social Security should be expanded and should stress the social insurance principle of social equity while downplaying individual equity.

The administration also wanted Social Security expanded. The Townsend Movement, still powerful, attacked Social Security's benefits as stingy—a criticism also employed by Republicans.

Meanwhile, controversy was raging about the Old-Age Reserve Account. Beginning with 1936 Republican presidential candidate "Alf" Landon, critics had charged that the reserve fund to be built up from surplus appropriations to the Old-Age Reserve Account was a sham; the government would simply spend the surpluses on general expenses and issue itself an IOU (the special debt instruments). The reserve fund would thus have nothing to pay future benefits with; Americans would have to be taxed all over again to redeem the IOUs with interest.

The reserve was real, its defenders retorted; government debt was one of

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[3] Frances Perkins, "Social Security: The Foundation," *New York Times Magazine,* August 18, 1935, pp. 2, 15; A. J. Altmeyer, "The New Social Security Act," *Vital Speeches of the Day,* October 7, 1935, p. 8.

the safest assets there were; besides, the surpluses had nowhere else to go—holding cash was silly, and the Act did not authorize purchase of private securities. Social Security's partisans realized that if the program were liberalized without raising taxes, this would preclude accumulation of a large reserve, and help end the controversy.

For all these reasons, the 1939 Amendments to the Social Security Act significantly liberalized the program. Survivor's benefits for dependent wives, children, widows, and parents were added. Retirement benefits were increased. Also, benefit payments would start on January 1, 1940,

Insurance vs. Welfare vs. "Social Insurance"

The purpose of *insurance* is to protect against quantifiable risks. Those subject to a given risk contribute small amounts of money to create a fund large enough to compensate for the losses of those who have contributed to the fund and for whom the risk has become a reality. Insurance thus creates the certainty of a small loss to forestall the possibility of a large loss. To receive a claim, the insured need only demonstrate that the event covered by the insurance has occurred. Insurance contracts are based on the principle of *individual* equity—the individual gets the benefits that he or she has paid for.

Welfare, on the other hand, involves using public funds to provide relief to those in need of support. To receive relief, a person must demonstrate need, usually via a *means test*. The rationale for welfare is *social equity*—the notion that a society needs to support those who, for one reason or another, cannot support themselves.

Social insurance is, at its most basic level, not insurance at all, but welfare without a means test. Tax revenues are used to make payments to beneficiaries; but, to receive such payments, one only needs to be facing specific conditions, such as advanced years, disability, or unemployment, as defined by law. The amount of any benefits may be related to the individual's work history (rather than any demonstration of hardship or need), which can give social insurance some of the trappings of genuine insurance.

But there are two reasons social insurance is not genuine insurance.

First, a properly managed insurance program will maintain enough funds on hand to meet future claims, even if there are no further contributions from those who are insured. Social insurance programs seldom accumulate sufficient funds to pay future claimants, but pay beneficiaries out of current contributions (tax receipts) from others.

Second, social insurance benefits are typically skewed in ways designed to favor those whom the designers of the system believe are likely to be poor. For example, the retirement benefits due persons with a history of relatively low wages will "replace" a larger proportion of their pre-retirement wages, than they will for those with a history of relatively high wages. Such skewing violates the principal of individual equity that is central to genuine insurance.

rather than 1942.

However, taxes were not increased and other benefits were cut to keep the cost down. The lump-sum death benefit to the estate of persons under 65, originally equal to 3.5 percent of wage income since 1936, was cut to six months' benefits, paid to the widow, widower, child, or parent of the deceased. The other lump-sum benefits were dropped altogether.

Termination of the money-back guarantee and scaling back of the death benefit were, of course, permissible under Section 1104. These changes demonstrated that Congress could adjust benefits down as well as up, even eliminate them altogether; and that therefore one's "earned right" was not set in stone.

The removal of the money-back guarantee also substantially diluted the principle of individual equity, thereby greatly weakening Social Security's resemblance to insurance. Yet the selfsame amendments also officially relabeled Social Security as "insurance"! The insurance language removed from the original bill was restored. The Amendments titled the program "Old-Age and Survivors Insurance." Social Security's taxes were relabeled "contributions." Title VIII of the Social Security Act was transferred to the Internal Revenue Code as the Federal Insurance Contributions Act (FICA).

An Old Age and Survivors Insurance Trust Fund was created at the Treasury. It had the same nature and functions as the Old Age Reserve Account. The only crucial difference was that whereas the original Act stipulated that Congress would appropriate monies to the Old Age Reserve Account annually, the amendments called for appropriating to the Trust Fund an amount equivalent to 100 percent of the revenue raised by the FICA taxes automatically each fiscal year beginning with the one ending June 30, 1941. A Board of Trustees was created to manage the Trust Fund.

In short, the 1939 Amendments wrote into the law the semantic and institutional framework—"insurance," "contributions," and a sham "trust fund"—that has been used ever since to promote Social Security and to shape the public's understanding of the program. Yet the fate of the lump-sum benefits and the money-back guarantee proved that the impression of certainty and security given by this language, and the phrase "earned right," were illusions.

Misleading Marketing

The campaign to market Social Security after the Amendments was therefore highly misleading. The September 1939 pamphlet *Changes in the Social Security Act: Old-Age Insurance,* for example, said in part:

> *It is an insurance plan* [italics in original]. You pay a tax, and so does your employer, to help pay the cost of the benefits you will receive. In other words, you pay a sort of premium on what might be called an insurance policy which will begin to pay benefits to you when you are 65 or over, or to your family when you die.[4]

Likewise, leaflets and circulars published in 1940 frequently used the word "insurance" and stated that the tax money "goes into the Old-Age and Survivors Insurance Trust Fund under the United States Treasury, from which insurance benefits are paid," and that the taxes are "similar to premiums paid on an insurance policy." The 1943 *Old-Age and Survivors Insurance for Workers and their Families* added, "because the worker has helped to pay for his benefits, they come to him and his family *as a matter of right* (our italics)."[5]

Mainstream media uncritically echoed all this. Magazines such as *Newsweek* and *United States News* referred to Social Security as "insurance," to the government as "in effect...writ[ing] insurance policies guaranteeing to pay monthly benefits," to taxes as "premiums," to benefits as "available as a matter of right," and to beneficiaries as "policyholders."[6]

Further Expansions

In 1950 coverage was extended to most nonagricultural self-employed, and to regularly employed farm and domestic workers. All persons aged 62 and over could now become eligible to receive full benefits with just six quarters of coverage—a great departure from individual equity, further weakening the analogy with insurance. Benefits were increased by an average of 77 percent, slightly exceeding total price inflation since 1937. The tax rate had been frozen at the initial one percent; the 1950 legislation raised it to 1.5 percent each for employers and employees, and added a self-employment tax for the self-employed now participating.

Another massive expansion occurred in 1954. Compulsory participation was extended to self-employed farmers, other farm and domestic employees not added by the 1950 Amendments, various self-employed

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[4] Social Security Board, *Changes in the Social Security Act: Old-Age Insurance,* I.S.C. no. 35, temporary edition, September 1939, p. 3.

[5] Social Security Board, *2 Plans for Old-Age Security,* I.S.C. no. 42, n.d., pp. 1-3; Social Security Board, *What is Social Security? A Brief Explanation,* I.S.C. no. 1, July, 1940, p. 10; Social Security Board, *Old-Age and Survivors Insurance for Workers and their Families,* I.S.C. no. 35, January 1943, p. 3.

[6] "The New Social Security System: Questions, Answers for Workers, Employers," *United States News,* August 14, 1939, p. 3; "U.S. Social Security Payoff Starts in New Year for 912,000," *Newsweek,* December 25, 1939, p. 10; "Billions for the Old Folks," *United States News,* January 5, 1940, p. 18; "Social Security Plan: Five Front Extension of Act Would Add 27 Million to Rolls," *Newsweek,* October 13, 1941, p. 17.

professionals, such as architects, and miscellaneous other occupations. Four million persons were given the option of participating in Social Security, mostly state and local employees who already had their own retirement programs, clergy, and members of religious orders. Almost every occupation was now covered except for a few professions and Federal government workers. Roughly 6.6 million current beneficiaries received a 13 percent increase in benefits. All this would of course increase future costs, and the tax rates scheduled for the 1970s were raised accordingly.

In 1956, Disability Insurance was added, paying monthly benefits to totally or partially disabled workers aged 50-64. Benefits would also go to dependent children aged 18 or older who had become totally disabled before turning 18. The Disability Insurance Trust Fund was created to pay these benefits. The Social Security tax was raised to cover the costs, by 0.25 percent of taxable payroll each for workers and employers, and 0.375 percent for the self-employed, the revenues to go to the DI Trust Fund.

Agitation began in the 1950s to add health care benefits. The 1965 Amendments created Medicare. In addition, Congress repeatedly increased OASDI benefits, partly as *ad hoc* adjustments for price inflation, and partly out of the generosity and ambition of politicians. In 1972, for example, President Richard Nixon and congressional Democrats competed in raising benefits in an election year. In these years benefits rose a total of 77 percent. Taxes were raised to cover the resultant higher projected costs. In 1972 a Cost of Living Adjustment (COLA) was added to adjust benefits annually for price inflation, beginning in 1975.

1970s-1980s: Crises and Rescues

In the mid-1970s, Social Security's financial outlook collapsed. The 1974 *Annual Report* projected a large deficit over the 75-year period 1974-2048 and the following year's report almost doubled the projected deficit. The main reasons were the much higher future retirement costs due the baby-boom generation born after World War II, the automatic indexation of benefits for price inflation, and the fact that slower economic growth and a below-replacement fertility rate would yield more slowly growing, or perhaps even declining, revenues.

Also, for the first time, Social Security faced a *short-term* financial crisis. Unanticipated economic developments including a deep recession followed by "stagflation" (simultaneous high unemployment and high price inflation), raised costs and depressed revenues. Moreover, apparently due to a drafting error, the cost-of-living adjustments enacted in 1972 resulted in benefits that were adjusted for price inflation twice.

Faced with the impending ruin of Social Security, Congress enacted legislation in 1977 undoing the double indexing of benefits. It also greatly increased both the payroll tax rate and the maximum income subject to tax, measures bitterly unpopular with taxpayers.

Although intended to solve the problem, the 1977 rescue was inadequate, and the high price inflation of the late 1970s again drove Social Security toward insolvency. In 1980 the Board of Trustees reported that Social Security had run a deficit of almost $2 billion in fiscal 1979, and that its trust fund would run out by calendar 1985.

In 1981, President Ronald Reagan proposed cutting benefits to meet the crisis. Specifically, the early retirement (at age 62) benefit would have been cut from 80 percent of the age 65 amount to 55 percent; for 1982-1987, the formula used to calculate the age 65 benefit level would have had its "bend points," which skew the level of benefits in favor of lower income workers, increase by 50 percent of the increase in the average annual wage, not 100 percent; the date for the annual cost of living adjustment would have been changed from June to December; and disability benefit requirements were to have been tightened. Opposition was immediate and ferocious; Reagan suffered his first defeat in Congress. A chastened Reagan appointed a bipartisan commission chaired by economist Alan Greenspan to recommend modifications to Social Security to avert insolvency.

Congress enacted sweeping changes in 1983 that closely followed the Greenspan Commission's recommendations. These raised revenues and cut current and future benefits. The phasing-in of the 1977 tax increases was accelerated, with the 1985 increase taking effect in 1984, and the 1990 increase starting in 1988. The self-employment tax rate was increased to equal the sum of the employee and employer FICA rates. Benefit payments became subject to tax for the first time, in effect, introducing a sort of means test (i.e., those with substantial incomes over and above the Social Security benefits had to return a portion of those benefits in income taxes). As another revenue-raiser, Social Security was extended to all newly hired Federal workers, the President, the Vice-President, members of Congress, Federal judges, and other executive-level political appointees, and to most employees of nonprofit, charitable, educational and religious organizations. The provision whereby state and local employees could leave Social Security was rescinded.

The cost-of-living increases that were due in July 1983 were delayed until January 1984. But most benefit cuts were to occur in the future. After 2000 the retirement age would be gradually raised and early retirement benefits gradually cut (see Appendix A).

Subsequent Developments

The 1977 and 1983 tax increases drove Social Security's revenues above outlays and, from 1985 on, OASDI reported increasingly large annual surpluses. Employment growth had been substantially larger, and wage and price increases markedly less, than the Greenspan Commission had anticipated. Also, the retirements of the relatively small birth cohorts born during the 1920s and 1930s meant that benefit payments grew relatively slowly.

Beginning in 1998, the OASDI surpluses exceeded $100 billion a year. These monies accumulated in the Trust Fund as unmarketable Treasury debt. As of year-end 2002 the OADI Trust Fund held $1,378 billion. The availability and use of these monies for general government purposes led to charges, and widespread belief, that Congress was robbing the Trust Fund and squandering the reserve meant to help pay baby boomers' benefits—uncannily reminiscent of the reserve-fund controversy of the 1930s.

The 1983 legislation improved Social Security's outlook only temporarily. For that year the projected long-term 75-year "actuarial balance" was +0.02 percent of taxable payroll. (Calculations based on projected population, employment, wage rates, interest rates, and price trends indicated that if the payroll tax rate was *reduced* by 2/100 of 1 percent, the system could still meet all its benefit obligations through the year 2058.)

Almost immediately, however, the actuarial balance returned to deficit. It rose steadily, reaching -2.23 percent in the Board of Trustees's *Annual Report* for 1997. In other words, their calculations for that year indicated that the payroll tax would have to be *increased* 2.23 percent if the system was to meet all its obligations through the year 2072. The prosperity of the late 1990s prompted optimistic revision of various actuarial assumptions, reducing the actuarial deficit to -1.92 percent in the *Annual Report* of 2003.

Although successive Boards of Trustees reported that OASDI was not in long-term actuarial balance and requested remedial action, presidents and Congresses alike largely ignored Social Security's problems. In 1985 the Trustees warned that Disability Insurance faced possible trust fund depletion, since its beneficiary population was exploding. Repeatedly, the Board of Trustees begged Congress to act. Finally, in 1994, the Board warned that DI faced trust fund exhaustion and cessation of benefit payments in 1995 unless Congress acted. That year Congress reallocated the OASDI payroll tax rate to give DI more revenue.

Growing awareness of Social Security's coming crisis has spawned many reform proposals. The 1994-1996 Advisory Council on Social Secu-

rity, chaired by economist Edward Gramlich, generated three different reform plans. In 2001, President George W. Bush appointed a Commission to Strengthen Social Security, which recommended partial "privatization." Numerous reform bills have been introduced. As of this writing in mid-2003, however, none has been enacted. Argument and procrastination continue.

II.

SOCIAL SECURITY MYTHS AND REALITIES

A formidable body of misconceptions has grown up around OASDI. Unfortunately, these myths greatly influence the public's perceptions of the program and their attitudes toward revising it. Dispelling them is probably the most formidable obstacle to useful reform.

"Social Security is Insurance"

Social Security was "sold" to the American people as insurance, probably because it would not have gained the widespread support it did had it not been made to appear like insurance rather than a dole. The payroll tax, widely described as a "contribution" or "premium," created a powerful impression that the taxpayer was buying an annuity or old-age insurance. The writing of insurance language into the law in 1939, and the creation of the Trust Fund, strengthened the insurance analogy's apparent basis in reality.

The truth, however, is that Social Security is not insurance. It lacks the characteristics of true insurance. For one thing, as former Social Security Commissioner Arthur Altmeyer admitted in the Social Security hearings held in 1953 by Congressman Carl T. Curtis, Social Security has no contract, and a beneficiary's rights are statutory, not contractual, and are subject to revision by Congress.

Moreover, insurance scholars describe insurance as a method of risk management employing *risk pooling* and *risk transfer.* Social Security contains neither. Under risk pooling, a large population of persons, each of whom faces the uncertain prospect of a large loss, shares the risk by means of each person paying a small sum called a premium, which is based on actuarial calculations of the probability of that person's suffering the loss, thereby creating a fund out of which members of this population are compensated if the risk being insured against eventuates. Social Security taxes, however, are not true premiums because they do not reflect any actuarial calculation of risk borne by the taxpaying worker. Therefore the payroll tax is not a means of true risk pooling. Rather, it is set to cover the costs of benefits, the size of which is governed by ideological and political, not actuarial, considerations. For example, two workers might pay the same amount of OASDI taxes all their working lives, yet one will get a benefit 50 percent higher than the other if he is married and the other is single. This has no actuarial basis; no insurance company offers annuities paying higher incomes merely because the beneficiary is married. Such arbitrary adjust-

ments of benefits make a mockery of the idea that Social Security is insurance.

Risk transfer means that the possibility of financial loss caused by the risk's eventuating has been shifted from the individual to the insurer. An insurance company sets its premiums based on actuarial calculations of risk, and invests the revenues. If the calculations are inaccurate, the investments turn out badly, or both, the company risks loss or even bankruptcy. Under insurance, policyholders buy claims on the insurer, who bears a risk of loss or ruin if its resources do not suffice to meet those claims. Under Social Security, however, you "buy" a claim not on the "insurer," but on other taxpayers. And if the program's revenues are inadequate to pay benefits, Congress can, as it has in the past, simply raise the OASDI tax. Risk is transferred, then, not to the "insurer" but to the taxpayers. The alleged "insurer" assumes no risk at all.

Furthermore, insurance companies invest premium receipts in stocks, bonds, and other instruments to build up assets to help them meet future obligations to policyholders out of the resultant dividends, interest, and capital gains. Social Security, by contrast, does not have this forward funding. Indeed, since it is legally barred from buying private financial instruments, forward funding for OASDI is impossible.

The retirement earnings test, which functioned as a means test, necessarily exploded the depiction of Social Security as a program of annuities. Payment of a true annuity is not conditional on the income or assets of the beneficiary.

Finally, Social Security's financial mechanism is redistribution, not insurance. Whereas under insurance annuities are paid out of a fund built up from invested premiums, under Social Security money is taxed from one group and transferred immediately to another—just as is done under any other welfare program.

"Benefits are an Earned Right, Guaranteed by Law"

Benefits, Social Security's promoters and defenders have declared ever since it was enacted, are received "as a matter of right," and are "an earned right," which is "guaranteed by law." Here again, Social Security's advertising is at variance with reality.

The Social Security Act's Section 1104, "The right to alter, amend, or repeal any provision of this Act is hereby reserved to the Congress," necessarily makes nonsense of Social Security's vaunted "guarantee" and "rights." Congress can reduce or even eliminate benefits. There is nothing in the law that says it can't.

The retirement earnings test necessarily means the guarantee and earned right are conditional. If your benefit can be withheld or cut due to retirement income, your right to it is obviously not absolute, and the guarantee is meaningless. Since the retirement earnings test was present from the beginning, this inescapably means that the talk of rights and guarantees was misleading all along.

Moreover, Congress has repeatedly cut or even eliminated benefits. The 1939 Amendments removed the money-back guarantee and reduced the lump-sum death benefit to six times one's monthly benefit. They also augmented the retiree's monthly "primary insurance benefit" by an increment of one percent of the benefit computed by the benefit formula, multiplied by the number of years in which one was paid at least $200 in wages. But in 1950 Congress reversed itself and removed this increment. It also cut the death benefit from six months to three months of benefits.

The 1950 Amendments brought most nonagricultural self-employed under Social Security. They provided too that no retirement benefit would be paid for any month in which a retiree earned $50 or more in covered employment (a liberalization of the retirement earnings test). Taken together, these provisions meant that retired employees who had started their own businesses and had still received benefits (self-employment not being covered until 1950) would now lose their benefits if they earned $50 or more in self-employment. Their "earned right" and "guarantee" had disappeared.

Although most of the 1954 Amendments expanded the program, one capped the lump-sum death benefit at $255—at which level it remains to this day, *unadjusted for price inflation.* Also, Social Security eligibility conditions were revised so that anyone deported after August 1954 for illegal activity, conviction of a crime, or subversive activity would not receive old-age benefits.

Altmeyer admitted in the Curtis hearings that one's rights are statutory, and that there is no vested right to benefits. This was confirmed in the *Flemming v. Nestor* case (1960). On July 7, 1956, Ephram Nestor, a Bulgarian-born alien, was deported. He had been a Communist Party member during the years 1933-1939. In November, 1955, he became eligible for Social Security benefits and had begun receiving them. Effective September 1956, his benefits were suspended. Nestor sued, arguing that old-age benefits had always been depicted as "a right of the recipient which he has earned and paid for." He cited statements by politicians which characterized benefits as an "earned right." Nestor won in the U.S. District Court for the District of Columbia, which held that he had been deprived of a "fully

accrued property right."

Secretary of Health, Education and Welfare Arthur Flemming appealed to the Supreme Court. On June 20, 1960, the Court decided *Flemming v. Nestor* in the government's favor. Writing the Court's opinion, Justice John Harlan argued that Nestor's "right to Social Security benefits cannot properly be considered" to be of the order of an "accrued property right." Social Security's ability to pay benefits rests on necessarily inexact economic forecasts, hence Congress has to be free to modify the program as needed. Therefore, Harlan wrote, giving Social Security "a concept of 'accrued property rights' would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands," hence Section 1104. A beneficiary "has not such a right in benefit payments as would make every defeasance of 'accrued' interests violative of the Due Process Clause of the Fifth Amendment," which forbids depriving individuals of life, liberty or property without due process of law.[7]

Reagan's proposed benefit cuts also illustrate that Social Security's guarantee is illusory, that the security of benefits entirely rests on the mood of the administration and the Congress. That the Reagan cuts were defeated only shows that the beneficiary's only real protection is the belief by politicians that cutting benefits would be political suicide. The benefit taxation, increase in the retirement age (a benefit cut), and reduction in early retirement benefits enacted in 1983, and the 1993 increase in benefit taxation, further prove that the "earned rights" and "guarantee" are fictions.

"Social Security is Financed with a Trust Fund"

Most Americans believe that Social Security is funded from a trust fund that is accumulating assets to meet future costs. It is true that the OASI and DI accounts at the Treasury are called trust funds, that the OASI Trust fund has accumulated a large amount of government debt, and that that amount is projected to continue to increase for some time. As of the end of 2002, OASDI's trust funds held $1.4 trillion in assets, $165.4 billion above the 2001 level. The 2003 *Annual Report* projected that under intermediate assumptions, the trust funds will peak at roughly $7.5 trillion at the end of 2027. But that is as far as the resemblance to reality goes.

The truth is that the Trust Fund is a Treasury account called a "trust fund" for public relations purposes, to defuse the reserve fund controversy of the 1930s. During the Senate hearings on the 1939 Amendments, Senator Arthur Vandenberg asked Arthur Altmeyer what the purpose of the

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[7] *Flemming v. Nestor,* 363 U.S. 603, at 608-611.

proposed trust fund was. Altmeyer replied: "Well, to allay the unwarranted fears on the part of some people who thought Uncle Sam was embezzling the money."[8]

The language in the 1939 Amendments creating the Old-Age and Survivors Insurance Trust Fund was almost identical to that in the Social Security Act of 1935 which created the Old-Age Reserve Account at the Treasury. It necessarily follows that the OASI Trust Fund is simply a Treasury account. Also, a true common-law trust is an arrangement whereby one party (a "settlor") gives his own assets to one or more trustees to be managed according to certain stipulations ("terms of trust") on behalf of one or more beneficiaries. The trustees hold legal title to the property in the trust and the beneficiaries hold an equitable title to it—a claim that could be sustained in a court of law. None of these things is true of the Social Security Trust Fund. Congress is not the settlor, since it does not own the Treasuries in the "trust fund." Nothing in the 1939 Amendments creating the OASI Trust Fund gave the Board of Trustees a legal title to anything. *Flemming v. Nestor* ruled that you have no accrued property right to benefits—and if that is so, you necessarily cannot have a property right to the assets in the OASI Trust Fund from which the benefits are supposedly paid.

Also, the "trust fund" represents no true forward funding. Social Security's surpluses have *not* been invested in productive assets with any tangible value. They are not held, as private financial reserves typically are, in stock, bonds, real estate, mortgages, etc.—assets representing real, wealth-producing capital. Instead, they have been loaned to the U.S. Treasury, which in turn uses them to finance other government spending and reduce its need to borrow from the public. In exchange, Social Security receives from the Treasury "special issue" government securities. As critics of the old-age reserve pointed out in the 1930s, these are simply claims by the government on itself. These Treasury "securities" are *nonmarketable* promissory notes backed by nothing of tangible value—"IOU nothings" that cannot be used in any market transaction whatsoever. They have no price, and therefore no value.

When the time comes to use the phantom "surplus" to pay benefits, Social Security will present its "IOU nothings" for payment, and the Treasury will have to extract the money from the private economy, through higher taxes or borrowing from the public. And borrowing from the public will entail higher interest costs, a legally binding claim on Federal rev-

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[8] U.S., Senate, Committee on Finance, *Social Security Act Amendments: Hearings before the Senate Finance Committee on H.R. 6635,* 76th Cong., 1st sess., 1939, p. 81.

enues. The Social Security "trust fund's" only real assets, then, are the government's power to tax and the public's willingness to be taxed. However, as AIER warned presciently back in 1939, long before Social Security's tax burden on the young exploded to what were then unimaginable levels:

> The truth of the matter is that we (citizens of voting age today) are attempting to provide for *our own* old age at the expense of our children and grandchildren. We would not dream of assuming one-third of the burden that we are planning to place on the shoulders of those too young to know what we are doing, and others yet unborn...We are assuming that our children and grandchildren will be peculiarly eager to shoulder burdens which were not of their making.[9]

This being so, it is not true that the accumulation of the Trust Fund since 1983 represents a shift from pay-as-you-go funding to "partial advance funding" or "partial funding," as is often claimed. Social Security is not merely *underfunded,* as the long-term actuarial deficits indicate, it is *unfunded.* An asset with no market value cannot "fund" anything. It necessarily contributes *nothing* to its holder's ability to meet future obligations.

Another way to see this is to ask yourself, Suppose the OASDI "trust fund" did not exist? Then Congress would have to cover Social Security's future revenue shortfall by raising the payroll tax. By how much? By enough to cover the shortfall, of course—that is, by exactly the same amount as it would have to increase other taxes or borrowing from the public to pay off the phantom assets presented to cover the shortfall. And regardless of how the money was raised, whether by higher payroll taxes, by higher general-revenue taxes, or by higher borrowing, it would necessarily come from the same source, the only possible source: the private sector. The burden on the economy and the taxpayer would be exactly the same. The only difference would be the mechanism of imposing the burden. In other words, the "trust fund's" existence not only makes no true contribution to funding future obligations, its presence or absence makes no economic difference whatsoever! If Congress abolished the "trust fund" tomorrow and wrote off its "assets," Social Security's ability to pay the benefits of baby boomers would be unaffected.

"Social Security's Trouble is that Congress is Robbing the Trust Fund"

If there is a Social Security Trust Fund, and if it holds nothing but unmarketable IOUs, it follows, in the minds of many, that a nefarious Congress has robbed the Trust Fund and left an IOU, and that if only that

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[9] "Whither Social Security?," in American Institute for Economic Research, *Weekly Bulletin,* January 23, 1939, pp. 22-23.

had not happened, Social Security would be sound. This too is nonsense.

If there is no true trust fund, then it necessarily follows that there has been no trust fund robbery. Congress cannot rifle a trust fund that does not exist. Moreover, the Social Security Act mandated from the beginning that revenues above those needed to pay a year's benefits were to be used to buy special unmarketable Treasuries issued for this purpose, with the money itself thereby being made available to the Treasury for general use. Therefore, Congress is doing nothing underhanded: it is merely doing what the law requires.

It is simply an artifact of accounting that Social Security surpluses help offset on-budget deficits and thereby make unified budget deficits smaller. Crediting the Social Security Treasury accounts ("trust funds") with unmarketable Treasuries in amounts equivalent to OASDI revenues received, and debiting them by amounts equal to benefits paid, are routine operations of the Treasury, not consequences of a decision by Congress to steal Social Security money.

And, as we shall see, the coming Social Security crisis is being driven by demographics. That the OASDI Trust Fund contains unmarketable Treasury debt has nothing to do with it. Indeed, as noted above, the "trust fund's" existence or nonexistence makes no difference for Social Security's ability to meet its future obligations.

"Social Security is a Defined-Benefit Pension Plan"

In recent years Social Security's partisans have taken to describing it as a defined-benefit pension plan—that is, a plan which specifies the size of the pension benefit you will get upon retirement. The analogy looks plausible at first glance: Social Security does have a precise formula for determining an individual's basic monthly benefit, and specifies how that amount can be increased or decreased under various circumstances (e.g., retiring before or after the normal retirement age, or having dependent children). This enables the specific amount of one's retirement benefits to be calculated in advance, as Social Security does in the benefit statements it sends to taxpayers. However, the analogy looks plausible collapses upon closer inspection.

For one thing, pension plans, like insurance policies, are characterized by forward funding. While pension fund managers have latitude in their choice of assets to fund their reserves, such assets must be of "high quality." At the very least, any sound pension fund requires that the actuarial reserves of the pension program have *at least some market value.* This, of course, is precisely what is *not* true of Social Security.

Despite its "trust fund" trappings, and the large amounts of unmarketable Treasury securities accumulating in the "trust fund," Social Security remains a pay-as-you-go system. Because the funds paid in to Social Security are not invested in any meaningful way (but transferred immediately to beneficiaries or used to finance other Federal programs), they represent not a stream of monies going into a national defined-benefit pension plan, but simply a huge transfer of wealth, largely from current workers to current retirees.

A defined-benefit pension plan is a binding obligation on the employer in question. Employers are legally liable for the specified dollar benefits owed to employees. This is why companies must fund defined-benefit plans, and why the funding must consist of "high-quality" assets. Pension laws require that a minimum level of funding be maintained.

By contrast, the purported "defined benefits" specified by Social Security law are no such legally binding obligation set in stone. Section 1104 enables Congress to redefine them at will. They can be and indeed have been cut and even eliminated as well as increased. Social Security's "defined benefits" are defined as of right now. A malleable defined benefit is a contradiction in terms.

The analogy of Social Security to a defined-benefit pension plan has a special irony and inappropriateness because it is *illegal* for an employer to finance a pension plan on a pay-as-you-go basis. The first pension plans did in fact operate this way, but this meant that if the company went out of business, retired employees received no further benefits, there being nothing to pay them with. This led employers to set up separate trust funds for paying pensions, a practice the tax code encouraged by allowing employers to deduct payments into a "qualified" pension fund and not report them as income to their employees. The Employee Retirement Income Security Act (ERISA) of 1974 *requires* private employers offering pension plans to put cash into a separate trust or insurance contract solely for paying benefits. Private pension plans, in other words, are explicitly *forbidden* to operate the way Social Security does—which necessarily makes the analogy untenable.

"Social Security is a Savings System"

From the beginning, Social Security has had an account for each taxpayer, which gives the appearance of payroll tax money accumulating on the individual's behalf, as it would in a savings bank. But these "accounts" are merely records of tax payments, and contain no funds. The taxes are spent immediately as transfers to beneficiaries or on other Federal programs. And far from being a means of savings for old age, Social Security

taxes make it more difficult for individuals to save for their own retirement.

Furthermore, the Federal government's inability to forward-fund Social Security means that *Social Security cannot save.* "Trust fund" surpluses not returned to taxpayers must be spent in some way in exchange for internal IOUs.

Reality Check: What Social Security Does—and Does Not Do

Let us summarize by sorting out what Social Security does from what it does not do. Social Security pays transfers based on a presumption of need, intended to prevent poverty arising from various conditions such as retirement, death of a breadwinning parent or spouse, or disablement of oneself or one's parent.

In so doing, it provides the bulk of retirement income of many elderly persons, accounting for more than 50 percent of income of 43 percent of persons over 65. It is the largest single source of income for 65 percent of its beneficiaries for whom it provides 50 percent or more of total income. It is the only source of income for a 16 percent of beneficiaries. In 2000, Social Security furnished some 82.3 percent of income for aged units (i.e., married aged couples or an unmarried aged person) in the first money income quintile (incomes up to $9,295), 81.6 percent for units in the second quintile (incomes above $9,295 but no higher than $14,980); and 64.1 percent for units in the third quintile (incomes above $14,980 but no higher than $23,631).

Increases in benefit levels and coverage have caused the share of persons aged 65 or older who are poor to decrease from 35.2 percent in 1959 to just 9.7 percent in 1999 and 10.2 percent in 2000. Social Security has indeed, as its partisans point out, greatly reduced old-age poverty.

Moreover, since its benefits are augmented yearly with a COLA, it does provide protection against price inflation, which many private annuities and pensions do not. One of the greatest risks of a defined-benefit plan is the loss of benefit value through price inflation. Defined-benefit plans usually offer only partial or *ad hoc* indexing (*i.e.,* benefits are raised only when the level of a company's retirees benefits become an embarrassment that demoralizes the company's current employees).

It is also true, however, that Social Security does *not* contain any real guarantees; therefore, it provides *no* true security. First, Section 1104 vitiates any real guarantee. Second, the insecurity Social Security supposedly eliminates is in fact inescapable. Social Security was depicted as providing a sure, certain benefit, as opposed to the insecurity of stocks (which crashed

in 1929) or savings banks (which failed by the thousands in the 1930s). This was a source of its powerful appeal in the 1930s, when many Americans craved deliverance from economic insecurity.

Social Security *seemed* to deliver on its promise of security in the 1940s, 1950s, and 1960s. This, however, was due not to the nature of Social Security itself, but to the benign context in which it operated—low inflation, cheap energy, prosperity, a stable dollar tied to gold via the Bretton Woods system, a large and growing taxpayer population—which meant that Social Security was not under threat from external forces.

However, OASDI's recurring financial crises of the 1970s demonstrated that the insecurity spawned by economic fluctuations had not been escaped after all: serious inflation and recession drastically weakened Social Security's cash flow, and to meet this problem Congress had to modify taxes and benefits, which meant that individuals again faced insecurity, in the form of the prospect of loss through higher taxes and/or reduced benefits. This prospect was realized by taxpayers via the tax increases of 1977 and 1983, and by current and future beneficiaries via the benefit cuts enacted in 1983. Whereas in private saving and investment the individual faces economic insecurity directly, under Social Security this insecurity is borne indirectly through the vicissitudes of politics and policymaking.

It bears emphasis that Section 1104 is not wicked, perfidious, or unreasonable. For one thing, reservation of power is routine in legislation. For another, Congress simply must leave itself some way of modifying legislation such as Social Security to meet changing circumstances, so as to keep the government solvent and to prevent the government's programs from breaking the economy. No responsible Congress would lock itself into a rigid position about Social Security in the face of fiscal crisis, leaving taxes and benefits unchanged. Something would have to give.

In the past, the uncertainty in Social Security was borne mostly by taxpayers, whose taxes were repeatedly raised to cover rising costs. But occasionally beneficiaries too had the rules rewritten to their disadvantage, and further benefit reductions are all but inevitable.

Also, Social Security does *not* eliminate the need to save or invest for one's old age. Social Security was never intended fully to replace your preretirement labor income or to enable you to continue to enjoy the standard of living you have while working. To their credit, Social Security's administrators recognized this by depicting Social Security as a floor of protection, upon which the individual would build with his own saving and investing. Another image they used was the three-legged stool, Social Security being one leg, your pension from your job being the second, and

your own saving and investing being the third.

In short, Social Security is *not* an insurance, annuity, savings, or defined-benefit pension plan. It is an income redistribution program, plain and simple.

III.
THE SOCIAL SECURITY CRISIS

DESPITE its growing trust fund, Social Security remains, as we have seen, a pay-as-you-go system—a Ponzi scheme. Just as Mr. Ponzi's scheme collapsed when the stream of new investors dried up, Social Security will become unsustainable if the pool of new entrants (taxpaying workers) no longer grows rapidly enough to pay the program's benefits. Given current demographic trends, this will occur within the next twenty years.

A reminder is in order that the Social Security actuaries' projections of future costs, revenues, and so on, and dates of future events such as trust fund exhaustion, are *projections,* heavily dependent on the actuarial assumptions underlying them. So, although we will refrain for brevity's sake from cluttering the text with such qualifiers as "roughly" and "approximately" every time a projected figure or date is used, these figures and dates should be not be regarded as precise.

Demographic Roots of the Social Security Crisis

The high fertility period of 1945-1965, known as the baby boom, was followed by a fertility collapse. The fertility rate fell and remains below the replacement rate of 2.1 lifetime births per woman. The taxpayer population born after 1965, who will pay benefits for the huge baby-boom gen-

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TABLE 1: **TOTAL FERTILITY RATE, NUMBER OF COVERED WORKERS AND OASDI BENEFICIARIES (THOUSANDS), AND WORKERS PER BENEFICIARY, SELECTED CALENDAR YEARS, 1950-2040***

Calendar year	*Total fertility rate*	*Covered Workers*	*OASDI beneficiaries*	*Workers per beneficiary*
1950	3.03	48,280	2,930	16.5
1960	3.61	72,530	14,262	5.1
1970	2.43	93,090	25,186	3.7
1975	1.77	100,200	31,123	3.2
1980	1.82	113,649	35,118	3.2
1985	1.84	120,565	36,650	3.3
1990	2.07	133,672	39,470	3.4
1995	2.02	141,052	43,108	3.3
2000	2.06	153,517	45,166	3.4
2010	2.01	166,932	52,744	3.2
2020	1.98	175,428	68,441	2.6
2030	1.95	181,372	84,018	2.2
2040	1.95	187,554	91,379	2.1

* 2010-2040 under intermediate actuarial assumptions. Source: 2003 OASDI *Annual Report.*

eration when it starts retiring about 2010, will therefore grow more slowly than the beneficiary population it will support. The ratio of Social Security taxpayers (covered workers) to beneficiaries will decline accordingly. While 3.4 taxpayers support every beneficiary today, under Social Security's intermediate actuarial assumptions, this ratio falls to 3.2 in 2010, and to just 2.1 in 2040. Moreover, the fertility rate is projected to remain below replacement in future decades (see Table 1).

Another important demographic root of Social Security's financial troubles is rising longevity. Obviously, the longer people live, especially after they have gone on Social Security, the longer they will be collecting benefits and the higher will be Social Security's costs. Life expectancy for men born in 1940 was 61.4 years. That is, most men were expected to die before collecting any Social Security benefits at all. Those who did reach 65 in 1940 were expected to live only another 12 years. Women were not much better off.

By 2000, both life expectancy at birth and life expectancy at age 65 were much higher for both sexes. Under intermediate assumptions, baby boomers reaching age 65 will live much longer than earlier generations of beneficiaries (see Table 2). This, and their increased numbers, means the boomers will put a colossal burden on Social Security.

Current law leaves the tax rate at the same level in the future as it is now: 12.4 percent of taxable payroll. With fewer workers per beneficiary paying taxes at the same rate, and with beneficiaries not only exploding in number (more than doubling between 2000 and 2040) but also living longer, the arithmetic is inexorable: costs will eventually exceed revenues. Social Security will have to cash in the Federal debt in its Trust Fund to cover its shortfall. Under intermediate assumptions, OASDI's actuaries project that the combined OASDI Trust Fund will be exhausted in 2042, and Social Security's projected tax revenues will cover only 73 percent of projected costs. Put another way, in 2042 Social Security will not be able to pay full

TABLE 2: **LIFE EXPECTANCIES, SELECTED CALENDAR YEARS, 1940-2060***

	At birth		*At age 65*	
Calendar year	*Male*	*Female*	*Male*	*Female*
1940	61.4	65.7	11.9	13.4
1990	71.8	78.9	15.0	19.0
2000	73.9	79.2	15.8	18.9
2020	76.3	80.9	17.0	19.9
2040	78.3	82.6	18.3	21.1
2060	80.0	84.2	19.4	22.2

* 2000 preliminary; 2020-2060 intermediate assumptions. Source: 2003 OASDI *Annual Report.*

current-law benefits on time.

That is what most Americans think constitutes the crisis in Social Security: depletion and exhaustion of the Social Security Trust Fund and the program's consequent inability to pay full benefits on schedule.

This is partly because most people, especially current retirees and baby-boomer taxpayers, look to Social Security for retirement benefits both as an income source and a payback for the Social Security taxes they paid over their working lives; so, understandably, Social Security's ability to deliver on its benefit promises is an urgent concern of theirs.

But the focus on the depletion date is also a consequence of the program's structure, which funded with a payroll tax and operating a so-called "trust fund." This leads most Americans, especially politicians and the media, to focus on the health of the Trust Fund.

The Board of Trustees' *Annual Report* gives, among other things, the projected date of trust-fund exhaustion under intermediate actuarial assumptions. If this date moves farther into the future, as it has in recent years, this is widely taken as a sign that Social Security's financial outlook is improving. Thus, when 2002's *Annual Report* put the projected date of exhaustion at 2041, three years later than the date in the 2001 *Annual Report,* the *New York Times* reported that "The financial outlook for Social Security and Medicare improved in the last year..."[10] Likewise, Social Security's partisans cite the distant and receding exhaustion date to argue that Social Security is sound, making radical reform unnecessary. Congressman Robert Matsui (D-Calif.) called the 2002 *Annual Report's* projection "especially welcome. It clearly shows that Social Security is not facing the crisis that opponents claim...those who claim that [it] is collapsing are misleading the public." Privatization, Matsui concluded, is "unnecessary and dangerous." Likewise, economist Robert Kuttner wrote that "Social Security is healthier than previously thought...the system is fine until 2041." Like Matsui, Kuttner used this to dismiss reform proposals; privatizers' timing, he crowed, "could hardly be worse."[11]

The Real Crisis: Social Security's Unaffordability

Unfortunately, this national fixation on the exhaustion of Social Security's Trust Fund is leading us seriously astray in two respects. First, the accumu-

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[10] "Report on Social Security Adds 3 Years to Fund's Life," *New York Times,* March 27, 2002.

[11] Robert T. Matsui, "News Release: Trustees' Report Shows Social Security's Financial Health Improving," News Release, March 26, 2002, www.house.gov/matsui; Robert Kuttner, "Social Security's happy secret," *Boston Globe,* April 3, 2002.

lation of surpluses in the Trust Fund gives a badly exaggerated notion of Social Security's ability to pay its way. Not only is the unmarketable Federal debt in the Trust Fund useless as a means of forward funding, so that the Trust Fund's presence or absence makes no economic difference, but also the large and growing annual surpluses that Social Security's actuaries project to continue for the next several years mask, as Table 3 shows, a collapse in Social Security's cash flow surplus, i.e., the surplus of tax revenues over costs. Even now, less than half of Social Security's annual surplus is an actual revenue surplus; the rest is interest, paid in the form of additional unmarketable debt. Though the dollar amount of the surplus keeps growing, Social Security's cash flow will weaken until by the beginning of 2018 the payroll tax will just cover costs.

Beginning in 2018, Social Security will start running growing cash deficits, which means that some of the interest income accruing each year will have to be used to cover the shortfall. In other words, *even while the trust fund is still growing,* and over two decades *before* its projected exhaustion, Social Security will be making substantial and rapidly growing claims on the general funds of the Treasury, resulting in higher taxes or borrowing from the public. The fixation on the trust fund exhaustion obscures this weakness in Social Security's cash flow and the serious fiscal consequences.

Second, fixation on the trust fund exhaustion date is dangerously misleading observers about the nature of the coming crisis. The exhaustion date is an important piece of *programmatic* information, an indicator of Social Security's ability to carry out its mission: paying old-age, survivors and disability benefits to those qualified for them. But its significance is

TABLE 3: **SOCIAL SECURITY'S COLLAPSING CASH FLOW SURPLUS, CALENDAR 2003-2025***

(dollar amounts in billions)

Calendar year	*Total income*	*Minus Interest income*	*Equals Cash inflow*	*Minus Total outgo*	*Equals Cash flow surplus or deficit*	*Total surplus or deficit*	*Cash flow surplus as % total*
2003	$642.5	$87.5	$555	$477.9	$77.1	$164.6	46.8
2005	726.2	109.3	616.9	522.4	94.5	203.8	46.4
2010	987.9	186.9	801.0	691.4	109.6	296.5	37.0
2015	1,299.4	280.6	1,018.8	965.0	53.8	334.4	16.1
2016	1,366.4	299.8	1,066.6	1,035.4	31.2	331.0	9.4
2017	1,435.2	318.5	1,116.7	1,111.7	5.0	323.5	1.5
2018	1,506.2	337.4	1,168.8	1,193.8	-25.0	312.4	—
2019	1,579.0	355.5	1,223.5	1,280.8	-57.3	298.2	—
2020	1,653.1	372.7	1,280.4	1,374.7	-94.3	278.4	—
2025	2,038.1	434.2	1,603.9	1,916.0	-312.1	122.1	—

* Intermediate actuarial assumptions. Sources: 2003 OASDI *Annual Report,* Office of the Actuary.

strictly internal to the program. What matters from an *economic and fiscal* standpoint are Social Security's relationships to the budget and to the economy, i.e., its cost and affordability. The exhaustion date says nothing about these all-important questions.

The crucial indicator for fiscal and economic purposes is Social Security's cost—which, of course, is its projected outgo. This tells us what it will cost to honor Social Security's benefit obligations mandated by current law (see Table 4). As we have already established, which specific mechanism is used to pay these costs—payroll taxes, or liquidating trust fund assets and getting monies from general revenues and/or borrowing from the public—is immaterial. All these methods draw resources from the same source: the productive private economy.

Cost figures in current-dollar terms are self-explanatory. Cash deficit data in current dollars reveal the magnitude of Social Security's claims on the Treasury as its costs exceed its revenues. Measuring costs and cash deficits as shares of GDP indicates the size of Social Security's claims on the economy.

Under intermediate actuarial assumptions, Social Security will cost $478 billion in 2003 (4.38 percent of GDP) and $691 billion (4.34 percent of GDP) in 2010. As baby boomers retire, Social Security's cost explodes, more than doubling in just ten years, to $1,375 billion (5.40 percent of

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TABLE 4: **THE ECONOMIC IRRELEVANCE OF TRUST FUND EXHAUSTION: OASDI COSTS, REVENUES, CASH SURPLUSES/DEFICITS, AND ASSETS (billions current dollars) AND YEARS TO EXHAUSTION, 2003-2055***

Calendar Year	*Cost (Outgo)*	*Tax income*	*Cash Surplus/ Deficit*	*Trust Fund Assets*	*Years till Trust Fund Gone*	*Cost as % of GDP*	*Surplus/ Deficit as GDP*
2003	$478	$555	$77	$1,543	39	4.38	0.71
2005	522	617	95	1,927	37	4.29	.78
2010	691	801	110	3,382	32	4.34	.69
2015	965	1,019	54	4,874	27	4.77	.27
2020	1,375	1,280	-94	6,418	22	5.40	-.37
2025	1,916	1,604	-312	7,373	17	6.00	-.98
2030	2,574	2,006	-568	7,260	12	6.43	-1.42
2035	3,330	2,508	-823	5,610	7	6.62	-1.64
2040	4,195	3,126	-1,069	1,953	2	6.65	-1.69
2045	5,250	3,886	-1,365	—	-3	6.64	-1.73
2050	6,601	4,819	-1,782	—	-8	6.68	-1.80
2055	8,337	5,974	-2,363	—	-13	6.76	-1.92

* Intermediate assumptions. Source: 2003 OASDI *Annual Report.*

GDP, up 25 percent from 2003's share) in 2020. Social Security's rising share of GDP means that its claims on the economy will be growing faster than the economy that will have to meet them. As costs start outrunning revenues, Social Security's cash flow surplus becomes a deficit. Meanwhile the vaunted trust fund more than quadruples from 2003 to 2020, and its exhaustion is still over 20 years away. To Social Security partisans, this says that all's well, even as costs are soaring—which reveals the exhaustion date's uselessness for fiscal and economic purposes.

In 2040, two years before the distant exhaustion date that Social Security's partisans find so reassuring and deem a reason not to reform Social Security, projected costs will be $4,195 billion, almost twice times this year's figure, about six times 2010's, and 6.65 percent of GDP, over 50 percent bigger than 2010's share. In that same year, OASDI's projected cash deficit will exceed a trillion dollars. In 2050, the projected cost will be $6,601 billion, almost 14 times 2003's figure, and 6.68 percent of GDP, up 50 percent from 2003's share.

Once Social Security starts running cash deficits, unless Congress raises general revenue taxes or cuts on-budget spending, these cash deficits will translate into unified budget deficits, quickly running into hundreds of billions of dollars a year. By 2025 covering Social Security's cash deficit will cost roughly one percent of GDP.

Trust fund assets peak at about $7.5 trillion in 2027. When the trust fund is actually drawn down, the cash deficits will rise to over a trillion dollars a year. Exhaustion in 2042 means the Treasury must raise $7.5 trillion in just 15 years, meaning taxing or borrowing over one percent of GDP *every year,* to help finance *one* program. Even *partial* liquidation—to, say, the $4.4 trillion projected for 2037, meaning raising $3.1 trillion in ten years—will enormously burden the Treasury and the economy. Financing these huge Social Security deficits will mean huge budget deficits. This will necessarily mean substantial crowding out, which will impair investment and employment, which in turn will weaken the economy's ability to carry the soaring burden of Social Security costs. This will weaken Social Security's cash flow, worsening Social Security's cash deficits, and setting off a vicious circle of rising Federal borrowing.

To put this in perspective, total Federal spending averaged 22.2 percent of GDP in fiscal 1981-1990, 20.4 percent in 1991-2000, and was 18.4 percent in 2001. So in GDP-share terms, by 2040 Social Security's cost will be about one-third as much as the *total* cost of the Federal government in 1981-2001, and annual taxing or borrowing from the public needed to cover the Social Security deficit *alone* will be about 42 percent of the

TABLE 5: **SOCIAL SECURITY PAYROLL TAX RATES NEEDED AFTER "TRUST FUND" EXHAUSTION, WITH NO BENEFIT CUTS***

(as percentage of taxable payroll)

Calendar year	*OASDI cost rate*	*Minus benefit tax rate*	*Equals required tax rate*	*Minus current law tax rate*	*Equals increase in tax rate*
2045	17.91	.87	17.04	12.40	+ 4.64
2050	18.18	.90	17.28	12.40	+ 4.88
2055	18.57	.92	17.65	12.40	+ 5.25
2060	18.88	.95	17.93	12.40	+ 5.53
2065	19.15	.97	18.18	12.40	+ 5.78
2070	19.47	.99	18.48	12.40	+ 6.08

* Intermediate assumptions. Source: 2003 OASDI *Annual Report.*

averaged *total* Federal deficit in the Reagan-Bush years. These are obviously large and unaffordable claims on the economy.

The focus on the exhaustion date, then, is mistaken. The real crisis is not that Social Security's trust fund will be exhausted, but that Social Security will cost more than we can afford, *whether its assets are exhausted or not.*

Around 2010, the amount by which Social Security taxes exceeds benefits paid each year will peak at around $100 billion. Thereafter, this amount, which has been available to the politicians to spend on other Federal programs, will diminish. By around 2018 it will become negative—other tax revenues or borrowing will be needed to pay benefits. By 2028 or so, some of the unmarketable securities in the trust fund will begin to be redeemed, which will mean that even more general revenues or borrowing will be needed, if only to pay interest to genuine lenders instead of crediting it to the trust fund. In other words, long before the exhaustion date, Social Security will be bleeding the budget and the economy.

After the trust fund is exhausted, if payroll taxes are raised to eliminate cash deficits and make Social Security self-financing again, this will entail extremely high payroll tax rates. By inspection, the required tax rates listed in Table 5 will initially be at least *one-third* higher than the current-law rate, then rise still higher. Oppositely, if Social Security taxes are not increased, benefits would have to be cut by one-third if the system is to remain solvent. Is the prospect of such a drastic and catastrophic choice somehow acceptable because it is many years in the future?

Intergenerational Inequity

In the past, Congress responded to Social Security's earlier financial crises by raising taxes and cutting benefits, with the benefit cuts engineered to fall mostly on future beneficiaries rather than those already

receiving benefits when the legislation was enacted. In so doing, Congress greatly exacerbated a phenomenon intrinsic to Social Security: succeeding generations of beneficiaries receive less and less in relation to the taxes they and their employers paid.

The initial generation of beneficiaries paid very small amounts in taxes for only a short time before collecting their benefits. Some enjoyed fantastic windfalls. The most famous example was one Ida Fuller, who paid $22 in Social Security taxes, came out ahead with her first benefit check of $22.54, and ultimately received over $20,000 in benefits thanks to her longevity. The self-employed and elderly brought under Social Security in 1950 also received windfalls.

However, as the program matured, the beneficiary population grew, and benefits became more generous, later generations spent their entire working lives paying higher and higher taxes. Both the payroll tax rate and the maximum taxable income increased enormously. It necessarily followed that for each succeeding generation, total benefits exceeded lifetime tax payments by a smaller margin.

Obviously, the first generation of beneficiaries received large intergenerational transfers: virtually all of their benefits were paid for by the taxes of younger workers. Such transfers obtain whenever benefits exceed payroll taxes plus accrued interest, all expressed in present-value terms.[12] Expressed as a proportion of total benefits for cohorts of age 65 retirees from 1940 to 1970, the ratio of such transfers to benefits dropped from about 98 percent in 1940 to 68 percent in 1970. The ratio for females receiving benefits on their own decreased from 99 percent to 80 percent over the same period. These numbers imply that a male retiree in 1940 contributed only two percent toward the benefits he received, while a male retiree in 1970 contributed 32 percent. The corresponding figures for females were one percent and 20 percent, respectively.[13]

The tax increase of 1977 and the tax increase and future benefit cuts of 1983 necessarily greatly worsened this situation. In the two decades since 1983, the putative returns on Social Security taxes for various generations of Social Security taxpayers have been calculated in numerous studies using different methods. One of the most rigorous of these, by Dean Le-

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[12] More rigorously, the expected present value (PV) of transfers is the difference between the PV of lifetime payroll tax contributions and the PV of expected benefits, all adjusted for survival probabilities. See Michael J. Boskin, *Too Many Promises: The Uncertain Future of Social Security* (Homewood, IL: Dow Jones-Irwin, 1986), p. 187, footnote 14.

[13] See Douglas R. Munro and Donald O. Parsons, "Intergenerational Transfers in Social Security," in *The Crisis in Social Security: Problems and Prospects,* ed. Michael J. Boskin (San Francisco, CA: Institute for Contemporary Studies, 1977), pp. 65-86.

TABLE 6: **INFLATION-ADJUSTED INTERNAL RATES OF RETURN UNDER OASDI, SELECTED BIRTH COHORTS, AS ESTIMATED BY LEIMER**

(in percent)

Birth cohort	Rate of return: Present law	Rate of return: Balanced budget	Birth cohort	Rate of return: Present law	Rate of return: Balanced budget
1876	36.5	36.5	1975	1.9	1.8
1900	11.9	11.9	2000	1.7	1.5
1925	4.8	4.8	2025	1.7	1.2
1950	2.2	2.2	2050	1.7	0.9

imer of the Social Security Administration, employed calculations of the internal rate of return (IRR)—that is, the discount rate that equates the present value of benefits with the present value of taxes. For an individual worker, the IRR may be viewed as the interest rate that he would have to earn on annual savings in amounts equal to Social Security taxes paid, in order to be able to withdraw amounts in retirement equal to Social Security benefits received, leaving a balance of zero at the end of his life. Individuals' experiences vary greatly, however, not only because some die before ever collecting any benefits while others enjoy long retirements, but also because Social Security benefits vary greatly depending on whether the individual is or was married or has dependents in retirement. All this affects individual IRRs. So, in examining Social Security's performance, analysts usually focus on aggregate taxes and benefits.

Leimer calculated inflation-adjusted IRRs on the taxes paid and the benefits received by persons born in every year since 1875. Presumably all of the earliest "birth cohorts" are now dead, and there is no doubt, aside from statistical error, about what they paid and what they received. However, for later cohorts, the calculations increasingly reflect estimates and projections. For those now collecting benefits, the IRR calculation reflects estimated mortality, i.e., how long will they continue to collect? For those now working, the calculation also reflects estimated future changes in the national average wage (which will affect their benefits), as well as future levels of employment and labor force participation (which will affect aggregate taxes).

Table 6 summarizes Leimer's results.[14] The IRR was very high for the first birth cohort but fell rapidly as Social Security matured. These results assume the tax and benefit provisions of present law. However, Social Security is in long-term actuarial deficit, and changes based on tax in-

[14] Source: Dean R. Leimer, "A Guide to Social Security Money's Worth Issues," *Social Security Bulletin,* vol. 58, no. 2 (Summer 1995), p. 12.

creases and benefit cuts are inevitable. Accordingly, Leimer did a second set of IRR calculations to determine the effect on the IRR of a series of increases in the payroll tax, beginning in 2020, designed to bring Social Security into actuarial balance over the projection period through the year 2150. These results appear in the "Balanced budget" column. The early birth cohorts, no longer paying payroll taxes by 2020 by virtue of death or beneficiary status, are unaffected; but the younger cohorts have their IRRs depressed even further by the tax increases. For those born in 2050, the IRR becomes just 0.9 percent.

Of course, the farther analysts project into the future, the more likely their projections are to be upset by unforeseen events. The estimated IRRs in the table thus must be regarded as highly speculative. At best, they tell us what may happen under economic, demographic, and policy assumptions that the author deemed reasonable. If, for example, future population growth and participation rates fell only slightly short of the assumed levels, the IRRs could eventually turn negative. Such a trend could be exacerbated if payroll tax increases drive more workers into the underground economy.

Methods of determining Social Security's "money's worth" vary. Some analysts measured money's worth in terms of "payback period": an estimate of how long it takes a beneficiary or beneficiary couple to recover in benefits the Social Security taxes they paid. If the payback period is less than their expected remaining lifetimes after starting to collect benefits, Social Security is a good deal for them; otherwise not. Some studies simply calculated ratios of the present value of benefits to the accumulated value of taxes if the taxes had earned interest at the rate paid on government bonds. A ratio greater than one means that the workers in question come out ahead; a ratio equal to one means they just break even; and a ratio less than one means Social Security is a bad deal for them.

Because interest on government bonds can fluctuate significantly, other analysts employed the IRR. Some studies included only retirement benefits in their calculations; others took into account Social Security's survivor and disability benefits (which, incidentally, involve features such as indexing that are difficult or impossible to purchase privately). Regardless of the method employed, the findings are remarkably consistent across the studies: the later a demographic cohort's birth year, the lower the putative returns on Social Security taxes paid.

By some calculations, Americans born in 1990 or 2000 will receive negative returns—that is, under current law, these young Americans will pay more into Social Security in taxes than they will ever receive

in benefits.[15]

Needless to say, the foregoing estimates are based on the total taxes paid and the total benefits received or to be received by the persons born in a given year. The experiences of persons within an age cohort can, of course, vary markedly. Much of this variation reflects differences in how long individuals live, their marital status, etc. Because of the skewing of benefits toward low-wage persons, the putative returns for higher-income persons are likely to be much lower (perhaps even negative for those retiring in 2000 and later years) than indicated in the table above.

However, while money's-worth analyses help make clear Social Security's deteriorating outlook and rising costs, and underscore that people might do better by investing privately the monies taken from them in payroll taxes, *they are highly misleading*. They feed the mistaken notion that Social Security is an investment plan and that benefits are a return of a worker's taxes.

The fact is that workers' taxes have never been invested. There *is no* "rate of return," because there is nothing on which to earn a return! The main message of money's-worth analyses is not that people are likely to receive relatively little in relation to their taxes paid, but that the burden on workers of supporting the program is greater now than in years past, and that it will increase as the ratio of workers to beneficiaries shrinks.

The Political Crisis

One source of Social Security's enduring popularity is the belief that it is a "good deal" not only for the poor but for the American middle class. However, the deteriorating relationship between one's tax payments into Social Security and one's benefit receipts from it has affected public attitudes toward the program. People are increasingly questioning whether they will get their "money's worth" from Social Security.

Current retirees suspect (correctly) that they are not getting as good a "deal" as earlier generations of retirees. Many workers, especially younger ones, doubt that the benefits they can expect to receive in the future will be worth as much as the value of their payroll tax payments.

All this has affected Social Security's politics and policymaking in important ways. It has greatly increased younger Americans' discontent with Social Security and made them highly resistant to another increase in

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[15] Besides Leimer's article, another useful discussion may be found in Sylvester J. Schieber and John B. Shoven, *The Real Deal: The History and Future of Social Security* (New Haven and London: Yale University Press, 1999), pp. 218-228.

Social Security taxes, which in turn makes another rescue of Social Security based on massive tax increases highly unlikely, and constrains policymaking accordingly. It has generated a powerful and analytically sophisticated critique of Social Security on grounds of intergenerational inequity. Finally, the widespread awareness among the young of that intergenerational inequity, of their high tax burden, and of the much better yields available from investment in private securities, has been a major force driving demands for "privatization" of Social Security.

At the same time, dependence on Social Security for much or most of one's retirement income is, as we have noted above, widespread. Most Social Security beneficiaries continue to opt for early retirement. Partly because of the now-formidable income confiscation by the Social Security tax itself, many baby boomers have done little to accumulate savings and investments for their old age. Moreover, the poor performance of the stock market between 2000 and 2002 badly reduced what investments for retirement they managed to make. It all adds up to continued high dependence on Social Security in future decades, meaning massive resistance to any attempt to reduce benefits.

Furthermore, many people subscribe to the Social Security myths examined in the previous chapter. These firmly-held delusions make many Americans refuse to countenance benefit cuts.

The policymakers' options are narrowing. With virtually all of the labor force already participating, the potential for capturing more revenues by expanding Social Security coverage has been exhausted. Raising the maximum income subject to tax also raises future benefit costs because benefits are also based on income up to this ceiling. The only revenue-raising option left is increasing the payroll tax rate. The rate increases necessary to restore Social Security's solvency after trust fund exhaustion would, as we saw, be massive—and opinion polls repeatedly disclose widespread opposition to another payroll tax increase.

The fate of Reagan's 1981 proposals to cut benefits indicates the likely outcome of any future attempt explicitly to cut benefits for current beneficiaries. Tellingly, the benefit cuts enacted in 1983 were either pushed into the future or done indirectly via benefit taxation. Unfortunately, cutting benefits for generations born *after* the baby boom will do *nothing* to reduce the cost of benefits for the boomers themselves. And the projected collapse of Social Security's cash flow and exploding deficits already factors in existing benefit taxation. So the crucial task of reducing Social Security's costs to affordable levels entails the riskiest measure of all: substantial explicit reductions in benefits for current and imminent retirees.

Clearly, any attempt to deal with the baby-boomer retirement costs through taxes and benefit cuts has the potential for a classic political confrontation. Benefit cuts will frighten and displease both today's beneficiaries, many of whom will still be alive in the next two decades, and the boomers, among whom dependence on Social Security will also be widespread. Leaving benefits essentially untouched and trying to raise revenues enough to pay for them will probably generate discontent among younger taxpayers, who are already keenly aware of their burden. Spreading the pain between the old and the young by mixing somewhat smaller benefit cuts and somewhat smaller tax increases will merely spread the fear and anger almost everywhere. The political drawback of near-universal participation in Social Security is that nearly everybody has something, in many cases a great deal, to lose if taxes are raised or benefits cut.

Social Security's unaffordability therefore risks a political crisis without precedent in our history. As a coerced redistributive transfer, Social Security is a zero-sum game: the beneficiary's gain is the taxpayer's loss. The magnitude of the potential financial crisis, and the size of the sacrifices that will be necessary to cope with it, mean that sparing either generation will impose genuine hardship on the other. The crisis thus has the potential to pit generation against generation. The severity of the crisis and the phenomenon of universal participation mean that the Social Security crisis also has the potential to turn the whole population against the government.

The politics of the crisis will have economic consequences as well. The political risks involved in raising taxes, cutting benefits, or both, give politicians a strong incentive to defer action as long as possible, meanwhile relying on deficit finance to cover Social Security's growing cash deficits. As these deficits grow they may eventually translate into debt monetization and an accelerating and ruinous inflation.

IV.
OPTIONS FOR REFORM

PROPOSALS to reform Social Security range from minor tinkering that keeps Social Security's essential nature intact, to major changes such as investing Social Security funds in stocks or partial or total "privatization." Space permits examination of only a few representative plans, which will illustrate the main features, and problems, of most reform proposals.

PIA

In these discussions, "*PIA*" stands for "Primary Insurance Amount," which is calculated by the Social Security Administration (on the basis of its records of earning and taxes) for every individual eligible to receive benefits. Briefly, one's PIA is the monthly amount one would receive when retiring at full retirement age *before* any adjustments for marital status, dependents, early retirement, earnings after reaching retirement age, cost of living, etc.

For an individual who first becomes eligible for old-age insurance benefits or disability insurance benefits in 2003, or who dies in 2003 before becoming eligible for benefits, the PIA will be the sum of:

(a) 90 percent of the first $606 of his/her average indexed monthly earnings, plus
(b) 32 percent of the average indexed monthly earnings over $606 and through $3,653, plus
(c) 15 percent of his/her average indexed monthly earnings over $3,653.

These amounts, $606 and $3,653, are known as "*bend points*."

AIME or Average indexed monthly earnings are based on the history of one's earnings subject to Social Security taxes, indexed by changes in the national average wage.

COLA is the annual cost of living adjustment.

See the Appendix for more information on these and other terms.

Maintain with Minor Tax, Benefit Adjustments

Social Security's partisans maintain that there is nothing seriously wrong with Social Security, and that minor tax increases, benefit cuts, or both will suffice to keep it solvent.

This approach seeks to close the long-term actuarial deficit. The Board of Trustees' *Annual Reports* of the mid-1990s put the long-term actuarial deficit in the neighborhood of -2.2 percent of taxable payroll, and pointed

out that an immediate, permanent payroll tax increase of about 2.2 percent of payroll would eliminate the long-term actuarial deficit. Hence, enacting a mix of tax increases and benefit reductions sufficient to eliminate the actuarial deficit was sometimes called the "2.2 percent solution."

For example, the 1994-1996 Advisory Council on Social Security came up with dozens of such small changes, and estimated their impact on the actuarial deficit; Table 1 presents a sampling. We see that the projected deficit reduction can be surprisingly large. Moreover, most of these adjustments considered separately do not inflict much discomfort, and hence may have a good chance of being accepted by the public.

However, some of these changes might conflict with Social Security's

TABLE 1: **POTENTIAL SAVINGS IN LONG-TERM ACTUARIAL DEFICIT FROM SELECTED OPTIONS FOR CHANGING SOCIAL SECURITY BENEFITS**

Item	*Estimated Reduction in Long-Term Deficit (Percent)*
Set COLA to 60 percent of increase in Consumer Price Index (CPI) beginning December 1997.	99
Change automatic adjustment of PIA-formula bend points from increase in average wage to increase minus one percentage point.	71
Index PIA-formula bend points by the increase in the CPI instead of average wage (as under current law), beginning in 1998.	71
Reduce COLA by 1 percentage point beginning with 1998.	64
Reduce percentage factors (32 and 15 percent) applied to PIA-formula bend points by 30 percent (to 22.4 percent and 10.5 percent) over next 30 years.	61
Accelerate scheduled increase in retirement age, tie future increases to longer life expectancy, and gradually increase age of eligibility for early retirement benefits to 65.	58
Gradually raise retirement age to 70 for those born in 1967 and later.	45
Index first PIA-formula bend point by increase in average wage (as under current law) and second bend point by increase in CPI.	28
Set COLA for December 1997 and later equal to the lesser of the percentage increase in the CPI (as under current law) or the increase in the national average wage.	25
Gradually increase retirement age to 68 for those born in 1955 and later (instead of to 67 as under current law).	23
Increase number of years of earnings used to calculate AIME from 35 (current law) to 40.	21
Increase number of years of earnings used to calculate AIME to 38	13
Lower spousal benefit from 50 percent of PIA (current law) to 33.	8

Source: *Report of the 1994-96 Advisory Council on Social Security,* Volume I, Appendix III.

goals. If the goal is to ensure adequate retirement income, then changes that affect all beneficiaries proportionately are less desirable than ones that slow the growth of benefits of higher-income retirees more. Even raising the retirement age raises the issue of equity. Increasing it from 68 to 70 would favor higher-wage workers because they tend to outlive lower-wage workers. And although life expectancy is projected to continue increasing, this will not necessarily translate into an increased period of good health in which people can keep working. At some age it will not. If the objective is to help the truly needy, it would be better to base eligibility on something besides age rather than to keep raising the retirement age.

Some proposals stand little chance of adoption because they would be too unpopular. The options yielding the greatest savings are, of course, the ones that would encounter the most opposition. Limiting the COLA to 60 percent of the increase in the CPI would virtually eliminate the actuarial deficit, according to the Advisory Council, but could also be political suicide. Congress is much more likely to make smaller changes in hopes of postponing major reform.

Also, eliminating the long-term actuarial deficit will not necessarily eliminate cash deficits in the later ("out") years of the 75-year period. A long-term actuarial balance of zero does not mean that revenues equal costs every year. It means that the initial assets in Social Security's trust fund, plus the income stream over the period, just suffices to cover the costs over the period, including any annual cash deficits in the out years, and leaves a target level of assets in the trust fund at the period's end. Those cash deficits would still have to be covered by general revenue or borrowing from the public. So even with the long-term actuarial deficit eliminated, Social Security would still have an impact on the budget in the out years, perhaps a substantial one.

More fundamentally, eliminating the actuarial deficit does little to make Social Security more affordable. The 1995 *Annual Report,* on which the 1994-1996 Advisory Council's work was based, put the long-term actuarial deficit at -2.17 percent of taxable payroll. But the total summarized cost rate for the 75-year period 1995-2069 was 15.44 percent of payroll.[16] So eliminating the deficit through benefit reductions would produce a cost rate of 13.27 percent (15.44 -2.17), for a reduction in total cost over 75 years of just 14 percent (2.17/15.44). To the extent that the package raised taxes rather than cut benefits, the cost reduction would be even smaller.

Maintain Benefits, Invest the Trust Fund

The members of the 1994-1996 Advisory Council on Social Security

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[16] 1995 *OASDI Annual Report,* p. 23.

were unable to agree on a single recommendation. They developed and reported three different proposals. One, the Maintain Benefits (MB) plan, would essentially preserve the program's existing tax and benefit system. Future benefits would be trimmed by using 38 years rather than the highest 35 years of earnings for calculating the AIME. To raise the necessary revenue, all new state and local government workers would be required to participate in Social Security. In addition, all benefits in excess of the employee's share of payroll taxes would be subject to income tax, with the revenue used to help fund Social Security. Finally, the payroll tax would be raised by 1.6 percent of taxable payroll beginning in 2045.

A portion, rising eventually to 40 percent, of Social Security's trust fund would be invested in U.S. and global stock market indexes. These indexes, and the fund's overall investment portfolio, would be selected and monitored by an investment policy board appointed by the President. The hope is that the investment returns on equities will be high enough to maintain benefits promised under current law without raising taxes for another 50 years.

What would happen if the investments did not perform as well as expected? The Trust Fund would go into actuarial deficit. When this happened in the past, the government cut benefits or raised taxes. If the stock market boomed, however, it might be possible to increase benefits or cut taxes.

Both possibilities suggest a major concern about making Social Security's finances dependent upon the stock market: it gives the government a compelling interest in a perpetual bull market, and creates a strong incentive for politicians to exert pressure on fiscal and monetary policy to keep the economy and financial markets booming. Appointments to the Federal Reserve System's Board of Governors might be biased toward favoring monetary expansion, so as to promote bull markets. Not only would this impart an inflationary bias to monetary policy, but it could compromise the Fed's independence.

Moreover, putting trillions of retirement dollars under government management would partially nationalize American enterprise, i.e., create partial socialism. There is also potential for political mischief with investments. A small group of appointed officials would decide how to invest trillions of tax dollars. Although their charter supposedly would be limited to the fiduciary role of selecting the best investments for workers and beneficiaries, it is not hard to imagine their decisions being influenced by other considerations.

Suppose the Trust Fund held stock in a company being sued for sex or

race discrimination. How would the fund's supervisors respond to inevitable demands that it divest its shares? Would a government-owned and government-managed fund hold tobacco stocks, or stocks in companies that sell products made by cheap labor in China? Concentrating so much power in the hands of a few would invite political meddling in investment decisions. As Stephen G. Elkins of the National Association of Manufacturers observed, "As the debate over reforming Social Security proceeds, the question of government control over portfolios ought to be among the primary matters for consideration. And we can expect familiar voices to advocate 'investment in the public interest,' or some such. The prospect of *mega-scratch* available for ETIs [Economically Targeted Investments] under privatized Social Security will create a policy magnet with the kind of attractive force attributed to celestial black holes."[17]

Also, this plan would require higher general taxes or government borrowing. If surplus payroll taxes were invested in stocks, the Treasury would lose a revenue source. In addition, if part of the Fund were redeemed to invest the proceeds in stocks, the Treasury would have to raise money to repay principal and interest. Either taxes would have to rise, or the deficit would increase, or other Federal spending would have to be cut.

Small Publicly Held Individual Accounts

The second plan put forth by Advisory Council members would cut the traditional earnings-based benefit for future retirees, by extending the AIME computation period from 35 to 38 years and by raising the retirement age to 68 by 2011 (instead of 2027, under current law) and tying it afterwards to increases in overall longevity. Additional changes in the benefit formula would make it more progressive, which would further reduce benefits mainly for middle- and high-wage earners. Even so, the program would require more revenue, which would be raised by increasing taxes on benefits and bringing state and local government workers into the system.

The reduced basic benefit would be supplemented by a benefit financed by compulsory savings accounts, funded by a 1.6 percentage point increase in the payroll tax paid by employees. The government would collect and manage the revenue, but each worker would have an account held in his name. He would decide how to invest it, but his choice would be limited to stock and bond index funds selected by the government.

Any time after turning 62, the individual could elect to convert the accumulated value of his account into a stream of annuity income. If he

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[17] Stephen G. Elkins, "Correspondence: Targeting Social Security," *The American Spectator,* April 1996, p. 75.

died before retiring, the fund would pass to his estate, but if he died after annuitizing, his survivors would receive only a small payment, perhaps one year's annuity income. Married retirees would have the option of choosing a smaller annuity that would continue to be paid to the surviving spouse.

Annuitizing would be the only option for withdrawing funds. This restriction presumably is intended not only to assure a steady income until death, but to eliminate the possibility that shortsighted retirees would draw down their savings too fast. There would be considerable pressure for the government to bail out such people with additional benefits.

This proposal has some attractions. It does take some steps to address the crucial problem of Social Security's exploding costs. And unlike both the existing program and the MB plan, it contains a saving component for the individual. Moreover, it skirts the transition costs problem of more ambitious "two-tier" proposals such as the Council's third plan, which we take up next.

However, the smallness of the principal injections (1.6 percent of taxable income) means that accumulations would be modest for all but the highest incomes. A worker with a taxable income of $20,000 would have an annual principal increment of $320 ($20,000 x .016), meaning it would take him 50 years to save a principal of $16,000, which is pitifully inadequate given what the cost of living will likely be fifty years from now.

In contrast to the first proposal, this one puts much of the responsibility for investing on the individual rather than the government. An individual would receive a higher annuity income if his investments did well, but would get a smaller one if they did poorly. An important question is whether the government would bail out individuals whose investments did badly. There would be considerable political pressure to do so, especially because these would be government-mandated accounts financed with taxes and invested in index funds chosen by the government.

Political forces might also influence the annuity income rates offered to retirees, if they were set by the government rather than private insurers. Among other things, there would be pressure to provide inflation-indexed annuities, which few private insurers offer. On the other hand, if the annuities were sold by private insurers, there would be pressure to bail out annuitants if the companies failed. In addition, this plan raises some of the same concerns about the government's role in the financial markets as the first proposal. These include the economic and political implications of having the government choose the investments available to workers, and tying a huge mandatory savings and entitlement program

to the fortunes of the stock market.

"Two-Tier" Privately Held Personal Accounts

The third proposal is the most radical. It would shrink the traditional benefit the most, mainly by phasing out the current earnings-based system of benefits and eventually substituting a flat dollar benefit for all retirees equal to $410 per month in 1997 dollars.

This basic benefit would be supplemented by an individual savings account, funded by splitting the employee's share of the payroll tax into two parts or "tiers" and diverting five percentage points of the tax into the account. Unlike the second proposal's accounts, these accounts would be held and managed by individuals, not the government, and investment options would be much less restricted—much as Individual Retirement Accounts (IRAs) now operate. Upon reaching the retirement age (which would be raised just as in the second proposal), individuals could take withdrawals in any form they wanted. Any funds remaining upon death, before or after retirement, would go to an individual's estate.

The plan would eliminate the retirement earnings test. In addition, benefits would be subject to new income tax treatment and new state and local government workers would be brought into the system, as under the other proposals.

The transition to the two-tiered benefit would take much time. Taxes and benefits would remain roughly the same as they are now for workers age 55 or older. Only workers currently under 55 would invest a portion of their payroll taxes in savings accounts. Workers aged 25 to 54 would eventually get a benefit based partly on a pro rata share of the flat benefit, plus the funds accumulated in their personal savings accounts. Workers currently under 25 would get only the flat benefit plus their accounts.

The main advantage of this plan is that it gives individuals the most control over their investments. Although the accounts would be subject to regulation, much as IRAs now are, there would be less potential for political interference with investments than with the other two plans. In addition, by shrinking the guaranteed benefits to a floor of support, it does more—over the very long term, once it is fully phased in—to alleviate Social Security's financial problems.

The major disadvantage of this plan is its cost in the "shorter" term—the next 50 years. Because the flat benefit would not be fully phased in until 2040, well after the last baby boomer retires, this huge group would be entitled to larger benefits. However, diversion of five percent of taxable payroll into savings accounts would greatly reduce OASDI's revenue. The

plan would cover the resulting revenue shortfall either by raising the payroll tax by 1.52 percentage points or by taxing consumption. It recommends the latter, on the theory that it would encourage savings and shift more of the financing burden to retirees. It also calls for a huge increase in government debt over the next 40 years, equal to $1.9 trillion in 1997 dollars.

But financing the transition will have to compete with exploding claims on the Treasury because Medicare and Medicaid outlays will soar as the population ages. In that context raising the money may prove difficult, which may lead to debt monetization and inflation. Moreover, the taxing and borrowing needed to finance the transition may seriously impair the economy's performance, which in turn will depress equity returns below what two-tier plans assume.

Here again, the government would have a compelling interest in bull markets in equities, raising the problem mentioned earlier of biasing economic policy, especially monetary policy.

Although this plan comes closest to "privatizing" Social Security, it does not entirely return responsibility for planning their financial futures to the younger people most affected by it. It forces them to save for their retirement, rather than letting them spend or invest their earnings as they choose. Many young workers would probably rather save for a down payment on a house, pay back student loans and other debts, buy a car, take a vacation, etc. Full "privatization" would let individuals decide not only how to invest their retirement savings, but how much (if anything) to save for retirement. The risk, of course, is that people would not save enough and the government would end up paying for their retirement anyway—but if their expected benefit were small, it is likely that most people would try to save more. People could be encouraged to save, rather than forced, by adopting tax policies that make saving more attractive than spending. One possibility would be replacing the income tax with a consumption tax.

Critical Assumptions about the Stock Market

All three of these plans project that benefits under the reformed program would on average be at least as big as those Social Security pays now. However, this happy outcome rests on some dubious assumptions, particularly regarding investment returns. All three plans assume that the average real rate of return on stocks and long-term government bonds will be the same over the next 75 years as they were in 1900-1995. According to the Advisory Council, stocks provided a real annual return of 7 percent during this period and bonds provided a return of 2.7 percent.

These projections amount to little more than fantasy. There is little basis

for expecting securities to provide the same return in the future as they did in the long-term past. In particular, massive flows of Social Security revenues into and out of the markets could have a significant, if unpredictable, impact on the financial markets, the economy, and savings behavior. In addition, there have been prolonged periods when the return on stocks and bonds was higher or lower than the long-term historical average. Moreover, the assumption that stocks will consistently outperform bonds, thus providing the extra returns needed to finance projected benefits, is doubtful in light of historical experience. There have been long periods in which this has not happened. For roughly 25 years, 1961-1985, the return on stocks and 5-year Treasury bonds was roughly the same. For the 20 year period 1961-1980, the return on stocks and 90-day Treasury bills was about the same.

In 1996 John Dizard, *National Review's* "Gekko," argued that the idea that investing Social Security's trillions in stocks with the expectation that fabulous returns would bail out the program is nonsense. "The rest of the country seems to take sustained high returns for granted, but my Wall Street friends talk about Social Security privatization as the ultimate sign of a top.... [F]or the huge U.S. equity market, a 13 percent annualized return [like that achieved by the Chilean equity markets since its social security system was privatized] is a fantasy—we'd own the nearby planets as well as the world by the time the Generation Xers retired. There is of course a way around this mathematical impossibility—a dramatic 'correction' in the public equity markets."[18]

The uncertainty and volatility of investment returns has significant implications for the foregoing plans. Under the MB plan, the government would directly bear the investment risk—it would be relying on investment returns to help finance the current program and would have to turn to other revenue sources to make up any shortfall. Under the second plan, the size of the annuity that a person could purchase upon retirement would depend on the value of his accumulated savings. Under "two-tier" plans, the value of a person's account would vary during his retirement, unless he bought an annuity. How the government would deal with people whose investments did badly, or who made poor investment choices, under either piggybacked accounts or two-tier plans is a fundamental question that the Advisory Council did not address.

Will Privatization Really Increase Savings?

A widespread but misguided notion is that "funding" Social Security with private financial assets will increase the Nation's savings rate, boost-

[18] John Dizard, "Gekko," *National Review,* March 25, 1996, p. 32.

ing economic growth and enabling us to afford to keep the elderly in the style to which they have become accustomed. In reality, under the Advisory Council's MB and "two-tier" plans, the Treasury will be taking the same amount from the capital markets as Social Security is bringing.

Even the second plan, which calls for putting 1.6 percent of earnings in individual accounts over and above the existing payroll tax (in the expectation that the returns on those investments will compensate for benefit reductions) would only increase the savings rate to the extent that workers maintained their current savings rates after the 1.6 percent was taken out of their paychecks.

More to the point, we have long argued that the savings rate is only part of the problem of capital formation: the nature of the capital formed may be even more important. Mandatory diversion of hundreds of billions into the securities of well-established firms would surely reduce the funds available to the most dynamic enterprises—the small businesses and new ventures that have been the source of most of the growth of output and employment.

Other Difficulties with Privatization

Proposals to put some Social Security funds in the stock market reflect the hope (and it is only a hope) that the returns on those private financial assets will eventually serve to curtail the "pay-as-you-go" tax burden of supporting retirees. Yet, even if some of future retirees' benefits are funded with private assets, the Treasury will still have to find the huge sums needed to pay currently promised benefits while it waits for the payoffs. That need will only be exacerbated by using funds to "play the market" rather than to pay benefits.

Also, it is hard for us to understand how Social Security could be privatized in any conventional sense. The primary reason is simple: what private concern (insurance and annuity company, investment house, pension fund, etc.) would be willing to assume a multi-trillion dollar unfunded liability extending many decades into the future?

Or consider the oft-cited Chilean model. In 1981 Chile replaced its pay-as-you-go old-age social insurance program with mandatory individual retirement accounts into which individuals were required to put a portion of their earnings, invested in private pension funds selected by the workers. Workers entering the new system were given "recognition bonds," which they could redeem at retirement, for the value of their payroll tax payments into the new system.

This model seems attractive, but there are decisive differences between Chile's situation and ours. The Chileans financed the transition partly by

selling their many state-owned enterprises and undeveloped natural resources. The U.S. government, however, has no such state enterprises to sell. Much of its land is desert. In America, unlike Chile, virtually all useful physical assets are already in private hands. Almost by definition, anyone here who acquires a government-funded enterprise or government-owned property is buying a loser. Furthermore, Chile's population is much younger than America's, making their social security problem much less difficult to begin with than ours is. And the Chilean government, unlike ours, was running substantial budget surpluses, which made the transition easier.

Supporting the Elderly

The notion of retiring from productive life before one's productive abilities have been exhausted is a relatively recent one. Nevertheless, while some primitive societies abandoned their unproductive members in jungles or on ice floes, civilized societies provide for their elderly and infirm. Traditionally, this support came from the individuals' families. In more advanced civilizations, especially those with financial systems that facilitated long-term saving, individuals became able to provide for their old age. Finally, most industrial economies have some system, such as Social Security, of forcibly transferring income from workers to the elderly.

Despite the longing of those who deplore government handouts, the program's goal—ensuring the elderly some means of support—remains. Low birth rates and high divorce rates mean that large and extended families have become rare. Some people are improvident or unlucky. Having precluded much retirement saving by individuals, Social Security's high tax will cause continued high dependence on Social Security in the future. Given all this, we can expect that the government will continue transferring income from workers to the elderly.

Social Security is, to repeat, an income transfer program. Unless this is more widely recognized, efforts at reform are unlikely to address the real issues: what level of support do we want to guarantee to the elderly via transfers, what is to be the age and/or circumstance of those qualified for such support, how can we make such a system affordable, and what is the best way of financing it? Should the government continue to operate a "pension plan" designed to provide substantial incomes (i.e., above a basic subsistence)? The current system is clearly untenable. Without major changes, it will eventually make most workers poorer than the retirees they have to support.

AIER's Proposal: Equalize Benefits, Repudiate Myths

We believe that the solution is to make benefit payments even more

progressive than they are now. If the goal is to provide a basic subsistence to the elderly, Social Security's minimum payments may be too low and maximum benefits clearly are excessive. We believe that a successful reform should ultimately make benefits equal for everyone. *This means scrapping the notion that the program resembles savings or insurance.* This applies to both the benefits and the revenue that pays for them.

Equalizing benefits for all Social Security beneficiaries at a level that the productive members of society can afford cannot, in fairness, be accomplished quickly. Current retirees and those nearing retirement years have planned on specific levels of benefits that should not be markedly changed overnight.

Current recipients' benefits are based on their PIAs, and it is possible to calculate PIAs for younger workers (in the same way that the benefits of disabled workers, which are based on their PIAs at the time of disability, are calculated). One way to gradually equalize all PIAs would be to calculate all these amounts under current law as of a cutoff date. Thereafter, instead of computing increases in individuals' PIAs using the average wage index, all PIAs could receive the same *dollar* increase.

One way to compute the annual dollar increase in PIAs would be to base it on the COLA for the maximum benefit payable to an individual under Supplementary Security Income (SSI), the general revenue-financed program for elderly and disabled Americans with no other income source. In 2003 this benefit, for an individual living in his own household with no other countable income, is $552 monthly, and for a couple it is $829. (Since 1975, SSI benefits have been increased by the same percentage as the Social Security COLA.)

To reflect any general increase in living standards, the increase might be based on changes in the average wage. Under this regime, if the average wage rose 3.5 percent (reflecting, say, a 2.0 percent increase in the cost of living and a 1.5 percent increase in productivity), the increase in the maximum SSI benefit would be about $19 per month, raising the individual benefit from $552 to $571, and a couple's benefit by $29 per year. If these dollar increases were given to everyone collecting benefits, a couple now receiving the maximum family benefit of $38,472 (based on 175 percent of the maximum PIA of $1,831 a month) would receive an annual increase of $228, which would represent a decrease in purchasing power of about 2.5 percent. All other COLAs would fall between these two extremes.

The objective is to gradually decrease the purchasing power of the

benefits of those with high PIAs, who have been and will continue to be those best able to provide for themselves, and increase the purchasing power of the minimum payments that mainly go to the truly destitute. At some point, very few individuals would remain with PIAs above the minimum. Eventually, everyone would get the same amount.

Abolish the Payroll Tax

Our proposal should limit OASDI's future outlays. It would also eliminate vast amounts of bookkeeping for employers and for the government itself, because, after the cutoff date, keeping track of earnings histories and Social Security tax payments would be unnecessary.

More significantly, if Social Security was seen as just another federal program, there would be no need to maintain the fiction that it is insurance "paid for" by worker "contributions," and the link to payroll taxes could be broken for good. If this were accomplished, the payroll tax could be examined on its own merits or, as we believe, lack thereof. We believe that the appropriate course is to abolish the payroll tax. This would, of course, leave a gigantic void in Federal receipts. Something would be needed to replace it. Our candidate is a value-added tax.

A Value Added Tax

The value added by an enterprise is the difference between its revenues or sales and the cost of the goods and services purchased from other firms. A value-added tax (VAT) is essentially a sales or turnover tax, with the important difference that a specific enterprise gets, in effect, a credit for the taxes paid by its suppliers. This means that the tax base of a VAT includes the same base as payroll taxes (compensation of employees) *and* whatever is left over after suppliers and vendors have been paid, which is the return to capital (interest and profits).

A long-standing objection to a VAT is that it is regressive. However, a VAT is a proportional (neither regressive nor progressive) tax on consumption: it is regressive only to the extent that lower-income people consume a higher proportion of their incomes. Savings are not taxed. If a family with an income of $20,000 somehow saved $1,000 in a year, the value added tax on their consumption of $19,000 would be a lower proportion of their income than it would for a family with an income of $200,000 that spent it all. The current payroll tax claims a higher proportion of the income of the $20,000 per year family than it does from the $200,000 family, no matter what either family does with the money.

Because it is simple, and because enterprises have a strong incentive to declare their purchases from vendors, a VAT is comparatively easy to

administer. Compliance and so-called "horizontal equity" (the principle that those in equal circumstances pay equal taxes) generally are better than for income taxes—there are far fewer gray areas subject to interpretation and dispute.

With the broadest base of any tax, the VAT is a very robust revenue raiser. Thus it is with some trepidation that we suggest it. We stress that we only advocate a VAT as a *replacement* for the payroll tax and, because it taxes income from capital as well as labor, *as a replacement for the corporate income tax* as well.

Abolish the Corporate Income Tax

Congress imposed the corporate income tax four years before passage of the 16th Amendment to the Constitution permitting taxation of individual income. This reflects an early understanding that corporations do not pay taxes, they simply collect them on the government's behalf. The notion may have been that, with ownership of corporate equities concentrated among the wealthy, a corporate profits tax would fall disproportionately on the rich, and the tax may have been enacted as an "end run" around the constitutional prohibition on an income tax (Article I, Section 9 prohibits "a capitation or other direct tax, unless in proportion to the census.").

The corporate income tax was retained even after the 16th Amendment was ratified. Its significance for Federal revenues varied greatly over the years. For some years during World War II it raised nearly half of Federal receipts, but after the war its share of revenue fell, and is now less than 10 percent of receipts.

The top *marginal* rate of Federal corporate profits taxation has varied from one percent (in 1909-1916) to 52.8 percent in 1968-1969. Many industries faced much higher rates on "excess profits" during World War II and the Korean War, as did many oil producers under the 1980-1991 "windfall profits tax." As of the mid-1990s the rate was 35 percent, but the decline in significance of corporate profits taxes has not been simply a function of lower rates. The *effective* rate has usually been much lower than the marginal rate, because of various exemptions, credits, and methods of calculating profits (accelerated depreciation, in particular) designed to encourage corporations to behave in certain ways.

Who Pays?

Although the corporate income tax may have been imposed in an attempt to tax the rich, the notion that profits taxes are paid by rich stockholders is questionable. Many economists believe, based on simplified models of behavior and estimates of various elasticities and ratios, that the

corporate income tax is fully borne by all capital income earners (not simply stockholders).[19] This may be so in the short run; however, over the long run, the data suggest otherwise.

Both the nominal and the effective profits tax rate have generally decreased since World War II, with the effective rate declining more than the nominal rate. Yet after-tax returns to equity capital—a total that does not change no matter how the accountants, IRS auditors, or financial analysts "massage" its components of profits and depreciation—have changed little over the years, fluctuating around 15 percent of gross corporate product (equivalent to the value added) of nonfinancial corporations for the past 50 years or so. At the start of the period, pretax cash flow was nearly 30 percent of value added, with profits taxes taking half of this. As of the mid-1990s, pretax cash flow accounted for only about 20 percent of value added and profits taxes about five percent, leaving the same 15 percent for the stockholders.

This strongly suggests that profits taxes simply are shifted to and collected from customers in the aggregate and over the long term. The tax becomes another cost of doing business that becomes imbedded in the selling price. The profits tax would thus appear to function, in the long term and in the aggregate, as equivalent to a sales or value-added tax. This is a major reason why profits taxes should be abolished if a VAT were levied.

However, unlike a straightforward VAT, the profits tax is capricious. It *will* affect the shareholders of a given firm, when that firm's profits fluctuate in the short term. For example, if the hula-hoop fad revives, a hula-hoop manufacturer's profits, and taxes, will soar. If profits subsequently become losses, say, because the new plant comes on line just as the fad ends, the firm may be able to claim a refund for taxes paid in prior years. Perhaps more significantly, a given corporation's taxes can vary enormously to the extent that it can use various loopholes ("tax incentives") that Congress has written into the law.

Political Mischief

Thus the real mischief of a profits tax is that it enables politicians to grant favors. One reason why its effective rate has usually been far below the nominal rate has been that Congress often has permitted larger write-offs (for depreciation of plant and equipment, and for depletion of mineral resources) than are indicated by financial or economic accounting, thereby

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[19] See, e.g., a much quoted article by Arnold C. Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy,* vol. 70, no. 3 (June 1962), pp. 215-240.

reducing taxable income and profits taxes. Moreover, Congress has allowed various tax credits and exclusions that further have reduced the tax. These have not been uniform over time or even across industries; some have been written so narrowly that they benefit only one company! Such "tax incentives" reflect a history of lobbying to obtain legislation favoring special interests. When campaign contributions are solicited, these interests no doubt remember which politicians were "helpful."

Because the tax base would be enlarged, the VAT rate needed to replace the revenues now generated by the payroll tax and the corporate profits tax should be lower than the 12.4 percent OASDI tax and much lower than the 35 percent nominal profits tax rate. A lower tax rate on capital and labor would reduce the employment disincentives of the current tax system. And because a VAT would not distinguish between the returns to equity and debt capital, it would remove the current system's bias in favor of debt financing.

Various transition rules no doubt would be needed to ensure the continuity of employees' take-home pay and employers' costs before and after the cutoff date. Other provisions would be needed to ensure that the value added of financial corporations, sole proprietorships, partnerships, nonprofit organizations, and governments (where the notions of revenues or sales and the nature of personal compensation can differ from nonfinancial corporations) would remain in the tax base.

Outlook

Readers may be aware that a tax on the site value of land is the only tax that we believe serves to facilitate rather than hinder the economic process. We make the above recommendation only because the best should not be the enemy of the good; a VAT would be better than what we now have, even if better alternatives can be imagined. Readers who object to our recommendations should rest assured that we rate as close to nil the chance that Congress would adopt them. Politicians of both parties have painted themselves into a corner on the question of curtailing benefits and have a huge vested interest in maintaining the myth that beneficiaries have paid for Social Security. Given its decreasing contribution to Federal revenue, the corporate profits tax may exist mainly to keep the money flowing to "the best Congress money can buy."

V.
OPTIONS FOR YOU

WHAT does all this mean for you? To answer, let us first examine what is likely to happen with Social Security, then take up what this implies for you and finally, what you should do about it.

Social Security's Likely Outlook

Although projections of future outlays by Social Security's actuaries are best taken as rough indicators of their likely order of magnitude, it is clear that under current law, Social Security will soon become unaffordable. In its present form it is unsustainable.

Denial of this unpleasant reality has become widespread in America. It is crucial that you not make this mistake about Social Security. Do not assume that "they" will "do something" to save the program and protect your benefits. Assume that they will do something to *cut* your benefits.

Do not assume that faster economic growth will bail Social Security out. Faster growth *could* help keep the current system intact, but we might enter a period of low growth and accelerating inflation such as the 1970s. Do not assume that immigration will save Social Security. Unless more than matched by greater capital formation, higher immigration levels could depress labor productivity and real wage growth, with negative implications for Social Security's revenues. In any event immigrant workers eventually become beneficiaries. Assuming these things is leaning on luck. The stakes—your well-being in old age—are too high for that.

A gap between the rhetoric and the reality of Social Security already exists, and it is likely that more discrepancies will emerge. Politicians of both parties will pledge not to cut benefits for current retirees and baby boomers, but reality will force them to find some way to reduce costs. Because explicit benefit reduction will be politically suicidal, benefit cuts will be done covertly and deviously. Possible methods include higher and more progressive benefit taxation or further increases in the retirement age. Since projected further increases in longevity and declines in death rates will make it prohibitively costly to permit tens of millions of baby boomers to take early retirement, Congress will probably try to discourage early retirement by further cutting the early retirement benefit as a share of the PIA—to, say, 60 or even 50 percent; raising the age at which one can first qualify for early retirement from 62 to, say, 65 or 67; or both. Another likely indirect benefit cut will be revised computation of the Consumer Price Index, officially to make it "more accurate,"

but actually to reduce COLAs.

Social Security taxes will probably be raised, but insidiously, so as not to provoke the young. The demagogic appeals of class war being perennial, we might see the contribution and benefit base (maximum income subject to tax) increased for tax purposes, but *not* for computing benefits, as an underhanded stiff-the-rich measure. Introduction of progressivity in the payroll tax is another revenue enhancement with class-war potential. Congress may resort to partial general revenue financing. It has been proposed before. (In 1980 independent presidential candidate John Anderson proposed taxing gasoline 50 cents a gallon for this purpose.)

Politics being what they are, we can expect such pain-inflicting measures to be postponed as long as possible and, once imposed, to be inadequate. So for at least the first several years after about 2018, Social Security's cash deficits will likely be closed by asset redemption, which will almost certainly mean larger budget deficits.

Partial or total privatization is unlikely unless the stock market becomes strongly and persistently bullish. The Democratic Party has a long history of resorting to demagoguery about Social Security and made a strident effort at demagoguing privatization in the 2002 election. Since most baby boomers have done little to save for their old age, they will be heavily dependent upon Social Security, and their support for it will solidify as they near retirement. Once they have started receiving benefits, they are likely to oppose any attempt to privatize unless an explicit guarantee of their benefits is included—and they will have the numbers, and political clout, to get their way. (Having loudly made the guarantee, Congress will of course break it with underhanded cuts, pleading necessity.)

Implications for You

It is of the first importance that you grasp the connection between Social Security's prospects and your own—that you "connect the dots."

If you are already retired and drawing Social Security, you are in the demographic cohort least likely to be seriously injured by the crisis. The politics of Social Security make explicit reduction in benefits to current beneficiaries the measure least likely to be adopted. However, insidious benefit cuts through higher benefit taxation, revising the Consumer Price Index, etc. *are* likely and will at least somewhat reduce your retirement income. Because our political reward system encourages deferral of such measures, the older you are, the lower your chances of injury.

If you were born after 1945, however, it is likely that both the tax and the benefit provisions of Social Security will be changed to your disadvan-

tage. The longer action is deferred, the more serious your eventual injury will be. Moreover, the young have less political power than the old in this matter. It stands to reason that the younger you are, the worse your financial injury from Social Security's revision is likely to be.

The coming crunch in Social Security means that retirement will be increasingly difficult for most Americans. Most of us will have to work longer, and retire later, if we are able to retire at all. The likelihood is that Social Security's shortfalls will be financed by borrowing. At some point, the option of inflating the national debt away may become irresistible. This obviously carries grim implications for the purchasing power of your savings and investments, and therefore for your ability to retire.

The all but inevitable benefit reduction makes it very likely that workers will need to save and invest much more than they do now to provide for old age. At the same time, higher taxes, and the possibility of inflationary stagnation caused by massive borrowing to cover the coming

Keep Track of Your Earnings

The amount of your Social Security benefit and any benefits received by your dependents or survivors depends on your lifetime earnings. More accurately, it depends on the Social Security Administration's *record* of your lifetime earnings. These records, which are based on earnings reported by your employers, are not always accurate. Not uncommonly, there are mistakes in reporting and recording a worker's name, date of birth, or earnings. Indeed, a study conducted some years ago found that the official earnings records for millions of workers were inaccurate.

Although we believe that your prospective Social Security benefits will be inadequate for your retirement needs, you should make sure that the Social Security Administration's record of your earnings is accurate so that you will receive any and all benefits to which you may be entitled. Thus, you should periodically check your official earnings record for accuracy. To do this, you need a copy of your *Social Security Statement.* This is a concise record of the earnings on which you have paid Social Security taxes during your working years and a summary of the estimated benefits you could receive based on those earnings.

This statement is automatically mailed by the Social Security Administration each year, about three months before your birthday, to all workers and former workers aged 25 and older. You can also get a copy of it at any time by calling Social Security toll-free at 1-800-772-1213 and asking for the *Social Security Statement.* Request form (Form SSA-7004). You can also submit a request for the statement over the Social Security website, www.ssa.gov, or you can download the request form from this website and mail it in. You will receive your statement of earnings and estimated benefits through regular mail in two to four weeks.

deficits, will make it harder to do so. The painful but necessary implication is the need to curtail your current personal consumption so as to offset the inroads which these higher burdens will make on your investible money.

In short, **the coming Social Security crisis implies that to be in a position to enjoy a comfortable retirement you will have to work harder, save more, and live more austerely than you do now.**

If You're Young, Assume the Worst

If you are now working, **do not plan your retirement around Social Security.** Realize that benefits are malleable and will be cut. Assume that you will be stiffed in some fashion, and that Social Security will replace a smaller, perhaps much smaller, share of your labor income than it does for current beneficiaries under current law. Rely as much as possible on your own saving and investing. **Realize that you may have to delay retirement for several years, or even forgo it altogether.** In short, "Hope for the best—but prepare for the worst."

Realize too that the choices you make now—and not merely those regarding income, savings, and investment—will have decisive consequences for your old age. Unhealthy or irrational lifestyle choices will damage your prospects for living decently in retirement or even for retiring at all.

Employment: Now and in "Retirement"

It is vital that you **be flexible about your employment and be willing to learn new skills.** Not only is job insecurity rampant thanks to globalization and corporate efforts to minimize costs by shedding jobs, but it may be necessary for you to work more than one job. Obviously, the more skilled you are, the more employable you are, and the better able you are to command higher compensation for your labor. This will put you in a better position to save and invest for old age.

It is quite likely that you will be unable to afford to retire, or will have to work part-time in your old age, unless you had or have a secure, well-paying job with generous retirement benefits, or have been fortunate in your investments, or both. Unfortunately most Americans are not in this happy situation, so it will be helpful if you remain willing to learn and try new things as you age.

Saving for Retirement

The virtual certainty that your benefits will be cut if you were born after 1945 makes it imperative that you **save and invest as much as possible.**

TABLE 1: **RECOMMENDED REPLACEMENT RATES FOR VARIOUS LEVELS OF GROSS PRERETIRMENT INCOME**
(2003 dollars)

Gross Preretirement Income	*Recommended Replacement Rates* to Maintain Standard of Living*	
	Single	*Married*
$14,000	79%	86%
21,000	73	78
33,000	66	71
44,000	61	66
65,000	58	60
107,000	51	55

*See the *Report of the President's Commission on Pension Policy, 1981.* pp. 42-43.

How much? It depends on how much income you think you will need in retirement. Having an estimate of this will enable you to calculate an "income replacement rate"—the rate at which retirement income replaces pre-retirement earnings. A replacement rate of less than 100 percent may be adequate for most retirees, because as a general rule, costs of living are lower after you retire. **Warning: health care is a decisive exception.** As a rough guideline, replacement rates ranging from 50 to 100 percent are regarded by employers who sponsor private pensions as sufficient to maintain preretirement standards of living. The lower your average lifetime earnings, the higher your replacement rate should be.

For planning purposes, replacement rates provided by the President's Commission on Pension Policy may be helpful. In 1981, the Commission estimated replacement rates for single and married people at different

TABLE 2: **SHARES OF AGGREGATE INCOME FOR UNITS AGED 65 OR OLDER, BY QUINTILES OF TOTAL MONEY INCOME, 2000**
(Quintile limits in parentheses)

Source of Income	*First ($9,295)*	*Second ($14,980)*	*Third (23,631)*	*Fourth ($39,719)*	*Fifth*
(1) Retirement benefits	85.1	88.8	80.4	70.3	38.3
(a) Social Security	82.3	81.6	64.1	46.0	19.4
(b) Railroad Retirement	0.4	0.5	0.6	1.0	0.3
(c) Govt. employee pensions	0.7	2.4	6.2	10.2	9.4
(d) Private pensions, annuities	1.7	4.3	9.5	13.0	9.1
(2) Earnings	1.3	2.6	6.7	14.2	35.2
(3) Income from assets	3.3	5.1	9.4	12.8	24.2
(4) Public assistance	8.4	1.7	0.9	0.2	0.1
(5) Other	1.9	1.8	2.5	2.5	2.3
Total percent	100.0	100.0	100.0	100.0	100.0

Source: Social Security Administration, *Income of the Population 55 or Older, 2000.*

TABLE 3: **ESTIMATES OF SAVINGS NEEDED TO FUND EQUIVALENT RETIREMENT INCOME AT SELECTED INCOME LEVELS**

(1)	*x (2)*	*= (3)*	*(4)*	*(5)*	*(6)*	*(7)*
			——Amount provided by——			
Gross Preret'mt. Income	*Replacem't. Rate*	*Equivalent Retirement Income*	*Social Security*	*Pensions*	*Earnings and Assets*	*Unadjusted Assets Needed*
$15,000	0.78	$11,700	$8,500	$800	$2,400	$33,300
20,000	0.74	14,800	10,400	1,000	3,400	47,200
25,000	0.71	17,750	12,100	2,800	2,850	39,600
30,000	0.68	20,400	13,300	3,200	3,900	54,200
35,000	0.64	22,400	14,400	3,500	4,500	62,500
40,000	0.63	25,200	15,700	5,800	3,700	51,400
45,000	0.61	27,450	16,900	6,400	4,150	57,600
50,000	0.60	30,000	17,900	7,000	5,100	70,800
75,000	0.56	42,000	20,800	7,800	13,400	186,100
100,000	0.52	52,000	20,900	9,600	21,500	298,600
150,000	0.43	64,500	20,900	12,000	31,600	438,900

income levels. After adjusting for Federal and state taxes (using the 1980 tax structure, which has since been changed), and for lower work-related costs and savings rates during retirement, they suggested the rates shown in Table 1. Factoring in price inflation since 1980, we have shown the roughly equivalent 2003 nominal income levels.

Once you have estimated your needed retirement income, you must address where it will come from. The degree to which Social Security, pension benefits, personal savings, and earnings in retirement will sustain your preretirement standard of living obviously will depend on your individual earnings and work history. Table 2 shows the breakdown of total money incomes by source for units (married couples and unmarried persons) aged 65 or older in 2000. We see Social Security providing the lion's share of the lower retirement incomes, and pensions, earnings, and asset incomes furnishing very little. For persons with higher retirement incomes, Social Security is less important, and pensions, earnings, and asset incomes are important income sources.

Armed with the information from Tables 1 and 2, we can generate some minimum guidelines for estimating how much to set aside in savings for your retirement. Illustrative figures are in Table 3, giving the estimated portions of retirement income provided by Social Security, pensions, and personal assets and earnings for various pre-retirement income levels.

Column (1) gives estimated average gross pre-retirement income. Column (2), drawing on the replacement rates provided in Table 1, shows estimated replacement rates. Column (3), the product of (1) and (2), shows

the equivalent retirement income. Column (4) gives approximate Social Security benefits, rounded to the nearest $100, for the various income levels, generated by interpolating between the benefit levels given in Table 2 of Chapter I. Column (5) is based on the share of income provided by pensions (private and government employee combined) in Table 2 above. Column (6) is obtained by subtracting the sum of (4) and (5) from retirement income (3). This figure shows the retirement income that must come from savings and retirement earnings, after deducting Social Security and pension benefits.

In this discussion, we assume that the entire amount in column (7) is from savings. Although many "active elderly" want to keep a hand in a business or profession, many other retirees are incapable of active work. From the standpoint of financial security, it is prudent *not* to depend on active earnings in retirement.

Column (7) shows the total amount of assets needed to provide the income flow shown in column (6). For the sake of illustration, we have used the amount that would be required to purchase a straight-life dollar annuity that would yield the income shown in column (6). Currently, low-cost annuities offered by well-regarded insurance companies pay about $6 in monthly income per $1,000 invested (by a 65-year-old male). Thus, to calculate the amount needed to fund a given income flow: (a) divide the amount in column (6) by 12 to get the monthly income amount; (b) divide the quotient obtained from step (a) by 6; and (c) multiply the result by 1,000. Example: to fund the annual income flow of $2,400 shown in the top line of column (6), a) $2,400/12 = $200; b) $200/6 = $33.33; c) $33.33 x 1,000 = $33,300.

Our illustration assumes that you can buy an annuity yielding $6 in monthly annuity income per $1,000 invested. This may be optimistic. Some years ago, the top-paying annuities yielded more, as much as $8 a month; and some years before that, $12. As interest rates have fallen and insurance companies' profits have been squeezed, their policies have become less generous, and this trend may continue. Also, the younger you are when you buy an annuity (i.e., when you retire), the lower the monthly income it will provide (since the company expects to pay you annuity income over a longer life-span). By substituting a range of yields for the $6 figure we used, you can estimate a range of the savings you need to accumulate to provide adequate income during your retirement years.

It is important that you remember that these savings figures are minimums, because Table 3 is based on Social Security benefits under current law. In reality, benefits probably will be lower, perhaps sub-

stantially lower, meaning that your own savings must be correspondingly higher. Moreover, as we shall discuss below, a crisis is coming in health care which will have important effects on your ability to make provision for your old age. The virtual certainty that you will face substantially higher health care costs is another reason why the saving which you will actually have to do will almost certainly be much higher than the figures given in the table.

There are two ways to increase saving: increase after-tax income, and decrease consumption. Doing both obviously enables you to save more.

Protecting Against Price Inflation

Since the explosion of entitlement costs makes the long-term trend strongly inflationary, **buying inflation hedges is essential to protect your old-age income.** Social Security does provide inflation protection through the COLA. Unfortunately, if you were born after 1945, your Social Security benefits are likely to be cut, meaning the inflation protection given by the Social Security COLA will be less helpful for maintaining your real income in old age.

Private defined-benefit pension plans, as we saw, are vulnerable to destruction of benefit purchasing power through inflation. So are annuities, for the same reason. Therefore you will have to look elsewhere to hedge against inflation. What this means is that a substantial portion of your net worth should be in tangible items and equities (common stocks), rather than in fixed dollar claims.

In the long run, the prices of these items will presumably increase along with the cost of living, but in the short run their prices can go down as well as up. Holding tangible items and equities to avoid the near-certainty of a diminishing purchasing power of currency, means accepting increased short-term risk.

These and other issues are discussed in detail in AIER's book, *How to Invest Wisely*. For the moment we will only mention two fundamental principles to keep in mind.

First, *diversification* is the key to reducing risk. This not only means placing one's funds in a variety of holdings, but also that they should include items whose prices tend not to fluctuate together. Second, holdings in tax-deferred accounts (IRAs, 401ks, *etc.*) should mainly include income producing assets where the income can *compound* on a tax deferred basis. Tangible items and "growth" stocks that generate little taxable income belong in your taxable accounts.

APPENDIX
SOCIAL SECURITY: WHAT IT IS, HOW IT WORKS

ENACTED during the Great Depression, when poverty among the aged was widespread, Social Security was partly a response to this problem. Social Security sought to prevent poverty in old age by replacing some of the labor income lost upon retirement, and thereby provide a minimum floor or, in President Roosevelt's words, "some measure" of protection for the aged. It also sought to encourage retirement so as to enable unemployed younger Americans to obtain jobs then held by older ones. Finally, it was intended to promote unionization by removing the need for unions to provide old-age benefits for members, thus enabling unions to charge lower dues, and making it easier to recruit more members.

Essential Nature

Social Security is an example of "social insurance." As discussed in the box on p. 7, social insurance is essentially welfare without a means test. The rationale for Social Security is *social equity*—the notion that a society needs to support those who for one reason or another cannot support themselves—which is also the rationale for welfare.

But unlike welfare, Social Security benefits are paid to those who demonstrate conditions (such as reaching retirement age after gainful employment for a specified period of time) rather than need.

That the level of Social Security benefits payable to a given individual is related to that individual's work history gives the program some of the trappings of insurance: it demonstrates *individual equity* in the sense that what an individual gets out of the program is related to what he or she put in.

The fundamental principles of social equity and individual equity conflict. Individual equity is at the core of private insurance, whereas social equity is inspired by some ideological notion of social justice and entails redistribution. A benefit level, especially for a lower-income person, that satisfies one principle will likely violate the other.

Taxes

Social Security's main source of funding is taxes on labor income, up to a ceiling known as the "maximum income subject to tax," "maximum taxable income," or "contribution and benefit base." Labor income above this ceiling is neither subject to the OASDI tax nor creditable for purposes of computing benefits. Repeatedly raised by Congress in past years, the

maximum income subject to tax is now increased automatically every year to reflect increases in average wages. Beginning in 1937, a payroll tax was levied on the labor incomes of employees in occupations covered by Social Security, matched dollar-for-dollar by excises levied on their employers. The employee payroll taxes are known as FICA taxes, after the Federal Insurance Contribution Act (FICA). Beginning in 1951, the self-employed have also participated in Social Security, and pay a self-employment (SE) tax on their self-employment income. The initial SE tax rate was higher than the employee's FICA rate but less than the sum of the employee's and employer's tax rates. In 1983 the SE rate was raised to 100 percent of the sum of the employee and employer FICA rates.

The Social Security tax, all economists agree, is regressive—that is, extracting a higher proportion of lower incomes and a decreasing share as income rises. The tax is imposed at a flat rate up to the maximum taxable income. Since the ceiling has been increased enormously, the regressivity with respect to labor income has diminished slightly. But overall, the tax remains regressive, as its burden on very high labor incomes is minuscule. Moreover, interest, rent, profits, capital gains, other nonlabor income, and fringe benefits, which are received mostly by high-income persons, are not taxed by Social Security, further contributing to the regressivity of the tax.

Economists also generally agree that the employer's share of the payroll tax is really borne by worker. This tax shifting can occur either through lower money wages and fringe benefits than the worker would have received otherwise, or (sometimes) through higher prices and profits, i.e., lower real wages. Employers are able to shift their share of the tax to their workers because the aggregate supply of labor is very inelastic with respect to the Social Security tax—workers will not quit if the Social Security tax increases. Thus, when an employer's labor cost entailed by hiring a worker is increased because of the Social Security tax, he can offer the same amount of employment only by making an offsetting reduction in money wages and fringe benefits. Over the long run, then, the worker pays the employer's share of the Social Security tax by accepting lower wages than he would have received otherwise.

Social Security's initial tax rate was quite modest, only one percent of labor income up to a maximum taxable income of $3,000, for a maximum annual tax of $30.00. Coverage of the labor force has been repeatedly expanded, and the program repeatedly liberalized, since 1935. Its need for revenue has risen accordingly. Congress has three options for increasing OASDI revenues: expand the population of workers covered by Social Security, i.e., paying taxes (and eventually getting benefits); increase the tax rate; and raise the maximum income subject to tax. Congress has

TABLE 1: **TAX RATES, MAXIMUM TAXABLE INCOME, SAMPLE TAXES, 1937-2003**

Calendar year	*Maximum taxable income*	*Employee (FICA) tax rate*	*Self-employed tax rate*	*FICA tax $20,000 income*	*SE tax $20,000 income*	*Maximum employee (FICA) tax*
1937-1949	$3,000	1.000	—	$30.00	—	$30.00
1950	3,000	1.500	—	45.00	—	45.00
1951-1953	3,600	1.500	2.250	54.00	$81.00	54.00
1954	3,600	2.000	3.000	72.00	108.00	72.00
1955-1956	4,200	2.000	3.000	84.00	126.00	84.00
1957-1958	4,200	2.250	3.375	94.50	141.75	94.50
1959	4,800	2.500	3.750	120.00	180.00	120.00
1960-1961	4,800	3.000	4.500	144.00	216.00	144.00
1962	4,800	3.125	4.700	150.00	225.60	150.00
1963-1965	4,800	3.625	5.400	174.00	259.20	174.00
1966	6,600	3.850	5.800	254.10	382.80	254.10
1967	6,600	3.900	5.900	257.40	389.40	257.40
1968	7,800	3.800	5.800	296.40	452.40	296.40
1969-1970	7,800	4.200	6.300	327.60	491.40	327.60
1971	7,800	4.600	6.900	358.80	538.20	358.80
1972	9,000	4.600	6.900	414.00	621.00	414.00
1973	10,800	4.850	7.000	523.80	756.00	523.80
1974	13,700	4.950	7.000	653.40	924.00	653.40
1975	14,100	4.950	7.000	697.95	987.00	697.95
1976	15,300	4.950	7.000	757.35	1,071.00	757.35
1977	16,500	4.950	7.000	816.75	1,155.00	816.75
1978	17,700	5.050	7.100	893.85	1,256.70	893.85
1979	22,900	5.080	7.050	1,016.00	1,410.00	1,163.32
1980	25,900	5.080	7.050	1,016.00	1,410.00	1,315.72
1981	29,700	5.350	8.000	1,070.00	1,600.00	1,588.95
1982	32,400	5.400	8.050	1,080.00	1,610.00	1,749.60
1983	35,700	5.400	8.050	1,080.00	1,610.00	1,927.80
1984	37,800	5.700	11.400	1,140.00	2,280.00	2,154.60
1985	39,600	5.700	11.400	1,140.00	2,280.00	2,257.20
1986	42,000	5.700	11.400	1,140.00	2,280.00	2,394.00
1987	43,800	5.700	11.400	1,140.00	2,280.00	2,496.60
1988	45,000	6.060	12.120	1,212.00	2,424.00	2,727.00
1989	48,000	6.060	12.120	1,212.00	2,424.00	2,908.80
1990	51,300	6.200	12.400	1,240.00	2,480.00	3,180.60
1991	53,400	6.200	12.400	1,240.00	2,480.00	3,310.80
1992	55,500	6.200	12.400	1,240.00	2,480.00	3,441.00
1993	57,600	6.200	12.400	1,240.00	2,480.00	3,571.20
1994	60,600	6.200	12.400	1,240.00	2,480.00	3,757.20
1995	61,200	6.200	12.400	1,240.00	2,480.00	3,794.40
1996	62,700	6.200	12.400	1,240.00	2,480.00	3,887.40
1997	65,400	6.200	12.400	1,240.00	2,480.00	4,054.80
1998	68,400	6.200	12.400	1,240.00	2,480.00	4,240.80
1999	72,600	6.200	12.400	1,240.00	2,480.00	4,501.20
2000	76,200	6.200	12.400	1,240.00	2,480.00	4,724.40
2001	80,400	6.200	12.400	1,240.00	2,480.00	4,984.80
2002	84,900	6.200	12.400	1,240.00	2,480.00	5,263.80
2003	$87,000	6.200	12.400	1,240.00	2,480.00	5,394.00

Source: 2003 OASDI *Annual Report.*

repeatedly done all three. As of 2003, 96 percent of the labor force paid Social Security taxes; the FICA tax rate stood at 6.20 percent (the employer paying another 6.20 percent); the self-employment tax rate was 12.40 percent; and labor income up to $87,000 was subject to tax.

The payroll tax has become large enough to have significant pernicious economic effects. As Table 1 shows, the tax load has become heavy even for such modest labor incomes as $20,000, and has become especially punishing for the self-employed. It follows that one very important effect of the soaring Social Security tax has been to make it extremely difficult for working Americans, especially those of modest incomes, to do substantial saving and investing of their own for their old age. It has also become a major disincentive to self-employment and creation of small businesses.

Also, at its current level of 12.4 percent of taxable payroll (or 15.3 percent if we include the 2.9 percent of taxable payroll used to fund Medicare's Hospital Insurance), the payroll tax is a significant barrier to employment. It is the largest part of the "wedge" between what it costs an employer to take on an employee and what the employee actually gets.[1] Plant and equipment that can substitute for human labor are not subject to the payroll tax, nor, more to the point, is the capital used to finance them. Finally, it is a major reason why many low-wage workers choose to be "off the books," foregoing the protection of the labor laws, unemployment insurance, etc.

"Insured Status" and Eligibility for Benefits

Social Security provides monthly benefits to retirees, dependents, widows, spouses, and divorced spouses. "Insured status," or meeting the eligibility requirements for receiving retiree or disability benefits, or permitting your children, spouse or survivors to become eligible for benefits in the event of your disability, retirement, or death, is based on "quarters of coverage." A quarter of coverage (QC) is earned not merely by working for a calendar quarter in a covered occupation, up to a total of four per year, but by earning a certain amount. For years before 1978, an employee received one quarter of coverage for each calendar quarter in covered employment in which at least $50 were earned. In 1978 this was changed to one QC for every $250 in annual earnings. Earnings needed to receive a quarter of coverage increase automatically each year in proportion to in-

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[1] The other components of the "wedge" that are mandated by the Government include workmen's compensation insurance and unemployment insurance taxes. In contrast to Social Security taxes, these payments are related to the nature of the business, and the benefits paid are related to the worker's employment experience.

creases in average wages. In 2003, a worker received one quarter of coverage for every $890 of annual covered earnings.

There are three different categories of "insured status": "currently insured," "fully insured," and "disability insured." "Currently insured" status is acquired by any worker who has accumulated six QCs in the 13-quarter period ending with the current quarter. To be "fully insured," you must have at least six quarters of coverage, and your total number of QCs must equal or exceed the number of years elapsed since you turned 21. Once you have accumulated 40 QCs, you are permanently "fully insured." "Disability insured" status is acquired by any fully insured worker over age 30 who has accumulated 20 QCs in the 40-quarter period ending in the current quarter; by any fully insured worker aged 24-30 who has accumulated QCs during half of the quarters in the period from the quarter in which age 21 was attained up to and including the current quarter; and by any fully insured worker under 24 who has accumulated six quarters of coverage in the 12-quarter period ending with the current quarter.

One requirement, but not the only one, for eligibility for benefits is the insured status of the worker. A worker must be "fully insured" to qualify for the primary retirement benefits, and for his or her spouse to be eligible for auxiliary benefits. A deceased worker must have been either currently insured or fully insured at the time of death for his or her children (and their mother or father) to be eligible for survivors benefits. If there are no eligible surviving children, the deceased worker must have been fully insured at the time of death for his or her surviving spouse to be eligible for survivors benefits. A worker must be disability insured to be eligible for a primary disability benefit, and for his or her spouse to qualify for auxiliary disability benefits.

For those who qualify for benefits as spouses, widows, divorced spouses and dependents, benefits may not be available until either the beneficiary or the worker reaches a certain age, and there are various other conditions that must be met. If you fall into one of these categories, regardless of your income, it may pay to check with your local Social Security office about your possible eligibility for benefits. A surprising number of eligible people do not collect benefits simply because they did not know they were eligible and never thought to apply for them.

Social Security does not pay benefits automatically as soon as you become eligible. To begin collecting benefits, you must file an application. You should plan to do so about two months in advance, and have a copy of your birth certificate. The process may take longer and require more paperwork for the self-employed. For information on filing, or any other Social

Security question, you can call the Social Security Administration toll-free at 1-800-772-1213 or check its website, www.ssa.gov.

Retirement Benefits

Benefit calculation begins by reviewing your annual earnings history, as indicated by your payroll tax records, for the years prior to your 62nd birthday. During Social Security's early years, average annual earnings essentially were figured by adding up annual credited earnings and divided the total by the number of years worked. But chronic postwar price inflation led to inflated nominal earnings from one's later working years being lumped together with smaller nominal earnings from earlier years. Accordingly, when inflation accelerated in the 1970s, Congress mandated that calculation of average annual earnings include an adjustment for this distortion. Earnings for a given year are now multiplied by an "index factor" for that year, reflecting year-by-year changes in the national average wage, to bring them up to their approximately equivalent value at the time of eligibility for benefits.

The most notable feature of this provision is that because nominal wages have increased faster than prices in the postwar years, the adjustment is far more generous than one based on price inflation. In the 1951-1994 period, for example, the national average wage increased about eightfold, so in the 1994 benefit calculations, 1951 wages were multiplied by a factor of 8 to make them comparable to 1994 wages. During this period the consumer price index increased "only" about fivefold. Clearly, this adjustment overstates "real" earnings. Consequently, it inflates the benefits based on those earnings, and thus makes Social Security more costly than it would be if earnings were adjusted only for price inflation.

Once one's annual earnings have been indexed, the Average Indexed Monthly Earnings (AIME) can be calculated. The period used to calculate your AIME equals the number of full calendar years elapsing between the year you turned 21 (or 1950, if later) and the year of your first eligibility, usually excluding the lowest 5 years. In other words, only your 35 highest years of indexed earnings are averaged. Thus, if your real earnings had increased steadily over your career, only the last 35 years count. AIME is calculated as the sum of indexed earnings in this period, divided by the number of months in that period.

The monthly benefit payable to a retired worker who begins receiving benefits at the "normal retirement age" (NRA)—the earliest age at which one becomes entitled to full retirement benefits—or (generally) a disabled worker, is known as the Primary Insurance Amount (PIA). The PIA is calculated according to a formula breaking up the AIME into ranges bounded

by dollar amounts called "bend points," and replacing smaller shares of the AIME as the income level rises. Thus the PIA is (1) 90 percent of the AIME below the first bend point, plus (2) 32 percent of the AIME above the first bend point but below the second, plus (3) 15 percent of the AIME above the second bend point. These percentages are fixed, but the dollar amounts of the bend points increase every year, based on the increase in the national average wage. This is done to ensure that benefits levels keep up with wage increases, so that rates of earning replacement are consistent across generations of beneficiaries. For 2003 the first bend point was $606 and the second was $3,653.

The benefit formula depends on the year of eligibility or death, not on the year benefits are first received. Thus if you retired at 65 in 2003, your PIA is determined using the benefit formula that applies to all workers first eligible in 2000 (the "year of attainment" of age 62). The resultant PIA is then augmented by the COLAs effective for December of 2000, 2001, and 2002 to determine the PIA effective at age 65.

From the PIA formula, it is clear that benefits are progressive, replacing ever smaller shares of income as it rises. For 2003, the PIA replaces $90 of every $100 in labor income up to $606, replaces $32 of every $100 in income between $606 and $3,653, and replaces $15 of every $100 in income above $3,653. The PIA formula is thus the great leveler of the Social Security system, which makes the program highly progressive despite the regressivity of its taxes. People with higher incomes do get larger benefits, but only marginally so in relation to taxes paid.

Table 2 illustrates the progressivity of Social Security benefits by presenting estimated annual benefits for retirees turning 65 in 2003 with various earning patterns: low (career-average earnings assumed equal to about 45 percent of the Average Wage Index), medium (career-average

TABLE 2: **ESTIMATED ANNUAL BENEFIT AMOUNTS FOR RETIRED WORKERS WITH VARIOUS PRERETIREMENT EARNINGS PATTERNS,* CALENDAR 2003**
(benefits in 2003 dollars)

	Retirement at NRA (65 yrs. 2 mos.)		*Retirement at age 65*	
Earnings	*Annual benefit*	*Percent of earnings*	*Annual benefit*	*Percent of earnings*
Low	$8,475	56.1	$8,380	55.6
Medium	13,970	41.6	13,814	41.3
High	18,357	35.1	18,154	34.8
Maximum	20,929	29.8	20,692	29.6

* Intermediate assumptions. Source: 2003 OASDI *Annual Report.*

earnings about 100 percent of AWI), high (career-average earnings about 160 percent of the AWI), and maximum (each year's earnings equal to the maximum taxable income). For those with earnings above the maximum taxable income, benefits replace an even smaller share of total earnings.

The PIA formula also makes it unmistakably clear that contrary to popular belief and to misleading depictions of Social Security in many quarters, your Social Security benefits are *not* based on your Social Security taxes. Rather, your benefits are based on your lifetime *earnings.*

Most benefits differ from the PIAs on which they are based for a variety of reasons. Your monthly benefits will exactly equal your PIA only if you retire upon attaining the "normal retirement age" (NRA), are unmarried with no dependents, and do not receive certain other government pensions.

The normal retirement age, also know as the "retirement age," was fixed at 65 by the Social Security Act of 1935, and remained there until very recently. However, under the Social Security Amendments of 1983, the retirement age is being gradually raised. Beginning in 2003, the retirement age is rising by two months per year, reaching 66 in 2005 and remaining there until 2016, when it will begin rising again in two-month increments until 2022, to age 67 for those turning 62 in 2022, i.e., to 67 in 2027.

Retirement at the normal retirement age is not mandatory. You may retire early and collect benefits permanently reduced from the full retirement level by 5/9 of 1 percent for each month before age 65 that you retire. Thus if your NRA is 65 and you retire at age 62, your benefit will be permanently reduced by 20 percent (i.e., your PIA for the rest of your life will be 80 percent of what your PIA would have been had you retired at 65). If, for example, you would be entitled to a monthly benefit of $600 at age 65, if you retire at age 62 you will receive $480 a month; if you retire at age 64, your benefit will be $560. The 1983 legislation also mandates that beginning in 2000, early retirement benefits will still be available at age 62, but will be a smaller share of the full retirement benefit. For those born in 1938 and after, benefits collected earlier than age 64 will be permanently cut an additional 5/12 of 1 percent for each month under age 64. The effect is to gradually trim early retirement benefits from 80 percent of the PIA in 2003 to 70 percent in 2027.

Also, you can retire later and get larger benefits. If you wait until after 65, you receive a credit of a certain percentage of the PIA for each year you delay retirement until age 70, and your benefit increases accordingly. However, under the 1983 legislation, both early and delayed retirement benefits are declining shares of the PIA for workers born in 1938 or later. Table 3 summarizes the legislated changes in the NRA and in early retirement and

TABLE 3: **LEGISLATED CHANGES IN NORMAL RETIREMENT AGE, EARLY RETIREMENT BENEFITS, AND DELAYED RETIREMENT CREDITS FOR PERSONS REACHING AGE 62 IN 1986 AND LATER**

Year of birth	*Year of turning age 62*	*Normal retm't age (NRA)*	*% PIA credit per yr. delayed retm't*	*Benefit as % of PIA, beginning at age: 62*	*65*	*66*	*67*	*70*
1924	1986	65	3	80	100	103	106	115
1931	1993	65	5	80	100	105	110	125
1937	1999	65	6 1/2	80	100	106 1/2	113	132 1/2
1938	2000	65:2 mo	6 1/2	79 1/6	98 8/9	105 5/12	111 11/12	131 5/12
1939	2001	65:4	7	78 1/3	97 7/9	104 2/3	111 2/3	132 2/3
1940	2002	65:6	7	77 1/2	96 2/3	103 1/2	110 1/2	131 1/2
1941	2003	65:8	7 1/2	76 2/3	95 5/9	102 1/2	110	132 1/2
1942	2004	65:10	7 1/2	75 5/6	94 4/9	101 1/4	108 3/4	131 1/4
'43-'54	'05-'16	66	8	75	93 1/3	100	108	132
1955	2017	66:2	8	74 1/6	92 2/9	98 8/9	106 2/3	130 2/3
1956	2018	66:4	8	73 1/3	91 1/9	97 7/9	105 1/3	129 1/3
1957	2019	66:6	8	72 1/2	90	96 2/3	104	128
1958	2020	66:8	8	71 2/3	88 8/9	95 5/9	102 2/3	126 2/3
1959	2021	66:10	8	70 2/3	87 7/9	94 4/9	101 1/3	125 1/3
1960 +	2022 +	67	8	70	86 2/3	93 1/3	100	124

Source: 2003 OASDI *Annual Report.*

delayed retirement benefits.

There are numerous other adjustments, such as increases in benefits for those with spouses and/or dependents (see the section on family retirement benefits below), or (since the 1983 legislation) reductions in monthly benefits for those receiving other government pensions. These are essentially arbitrary. The upshot of all these adjustments is that your monthly benefit check can range from a fraction of your PIA to more than twice the PIA. *However, these adjustments are only coincidentally related either to the needs of the beneficiaries or to the finances of the system.*

The Retirement Earnings Test

Also, to receive benefits, retirees must meet the Social Security "retirement earnings test" (also known as the "earnings test"). The original Social Security Act stipulated that retirement benefits would be lost completely for any month in which the beneficiary had income from employment covered by the Act.

The retirement earnings test served the goal of removing older workers from the labor force so unemployed younger workers could get jobs. It also helped contain the cost of Social Security. However, it conflicted with Social Security's official characterization as an annuity program paying benefits as

an earned right without a means test. The retirement earnings test functioned just like a means test, of course, since it denied benefits to those who had means of their own in the form of earnings from covered employment.

Bitterly resented by the elderly, the retirement earnings test was repeatedly liberalized. Congress first amended it so that retirees could earn up to $15 a month before losing benefits. In 1950 Congress relaxed the retirement earnings test still further, raising the earnings limit to $50 a month and exempting beneficiaries aged 75 or older. The age provision was gradually liberalized; in 1955-1982, the retirement earnings test did not apply at age 72 and over; and in 1983-1999, it did not apply at ages 70 and over.

The limit on earnings was also repeatedly liberalized. After price inflation accelerated in the 1970s it was tied to increases in average wages, and Congress periodically legislated additional increases. Moreover, the rate of reduction in benefits was lowered until by 1978 benefits were cut by $1 for every $2 in earnings above the earnings limit. In 1990 it became $1 for every $3 above the limit for beneficiaries aged 65 to 69.

In 2000, Congress abolished the retirement earnings test for persons above the full retirement age. It remains in force for beneficiaries below the full retirement age; in 2002, a beneficiary below the retirement age could earn $11,280 without losing benefits; for 2003, the ceiling was increased to $11,520.

Family Retirement Benefits

When you retire, your spouse is entitled to a spousal benefit, equal to 50 percent of your PIA if he or she is at least 65. Alternatively, a spouse can apply for this benefit any time after reaching age 62, but it will be permanently reduced by 25/36 of one percent for each month by which the spouse's age is under the normal retirement age. Thus, if the NRA is 65 and the spouse elects to collect benefits at 62, they will be reduced by 25 percent. (This works out to a benefit equal to 37.5 percent of the PIA: 0.50 of the PIA x .75 = .375) In any case, no spousal benefit is payable until the retiree's benefits begin.

The "spousal" allowance, normally 50 percent of one's PIA (less if the spouse is under 65), is one of the more bizarre aspects of the system. If the sum of a retired couple's PIAs exceeds 150 percent of the larger PIA, the couple can receive more "living in sin" than in wedlock, and some elderly couples live thus for that very reason.

Families may be eligible for an even larger retirement benefit. A spouse caring for a child under age 16 is eligible to collect spousal benefits at any age, with no reduction for the spouse's age. Dependent children under 18

(19, if in high school) or permanently disabled are also eligible to collect benefits equal to 50 percent of the retiree's full benefit.

There is a maximum family benefit, which is based on the worker's PIA. Like all OASDI benefits, it is adjusted annually for inflation. The maximum family benefit is higher for retirement and survivor cases than for disability cases. In retirement and survivor cases the maximum is about 175 percent of the individual's PIA—between 150 and 188 percent for low-wage earners. In disability cases, family benefits are limited to the smaller of 85 percent of the AIME (or 100 percent of the PIA, if larger) and 150 percent of the PIA, but in no case is it less than 100 percent of the PIA payable to the disabled worker alone.

The maximum family benefit formula applicable to a worker depends on the year of attainment of age 62, onset of disability, or death. After the maximum family benefit for the year of first attainment is determined, it is adjusted with COLAs.

Survivor Benefits

Survivor benefits are available to spouses at virtually any age if they have young children, to dependent elderly parents, and to younger children as well, provided the deceased met the "insured status" requirements mentioned earlier. There is also a small lump-sum death benefit. Survivors of a deceased worker should always investigate their eligibility; never assume that you do not qualify because of income or other circumstances.

Of particular interest to retirement planners, a surviving spouse can claim a benefit based on the deceased's Social Security record as early as age 60. A benefit equal to the deceased's PIA is available only if the spouse waits until age 65 to claim it. Benefits claimed between ages 60 and 65 are reduced permanently, on a sliding scale. For a 62-year old widow(er) the benefit is 82.9 percent of the full benefit; for a 60-year-old it is 71.5 percent.

Disability Benefits

For Social Security purposes, disability is defined as the inability to engage in substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to last for a continuous period of not less than 12 months. Special rules apply for workers aged 55 and over who are disabled due to blindness. Generally, the law requires that a person be disabled continuously for five months before he or she can be eligible for disability benefits. Determination of disability is often difficult. Clear-cut cases of disability include terminal cancer, serious heart conditions, or loss of the use of limbs; such cases constitute about 75-80 percent of all disability claims awarded. Since

1980, the status of disability beneficiaries is supposed to be reviewed every three years, unless the beneficiary has been determined to be permanently disabled.

Disability benefits include benefits to the disabled worker, to his (her) spouse and children; disabled widow(er)'s benefits and childhood disability benefits. The disability benefit is equal to 100 percent of the disabled worker's PIA, computed as though he had attained 62 during the first month of his disability. Therefore, the amount of the disability benefit is the same as the normal retirement benefit, if the average earnings on which they are based are the same. Average earnings will depend, however, on the time of the onset of disability, and therefore so will the benefit. In some cases, total disability benefits paid to the worker and his dependents may be reduced if he is also receiving worker's compensation benefits.

One's disability benefit ends on the month preceding the earliest of (a) the month in which he dies, (b) the month in which he attains the NRA and therefore becomes eligible for full retirement benefits, or (c) the third month after the month in which the disability ceases.

Table 4 gives details of the various retirement, survivor, and disability benefits.

Special Minimum Benefit

Workers who have long work histories under Social Security with very low earnings may be eligible for a special minimum benefit, based on a special minimum PIA computation. This computation depends not on the worker's earnings but on the number of "years of coverage" over 10 and up to 30. A "year of coverage" is one in which the worker had earnings at or above a specified amount—25 percent of the maximum taxable income for years 1951-1978 and to about 18.7 percent of the maximum taxable income in subsequent years. The level of the special minimum PIA is the same for workers having the same number of years of coverage, regardless of age or year of first eligibility. Increases in the special minimum PIA are tied to the COLA.

Under these provisions, a worker with 11 years of coverage qualified for a special minimum benefit of $30.90 per month in 2002. The monthly benefit increases proportionately as the years of coverage increase. For example, 20 years of coverage yield an approximate monthly benefit of $309.00 for 2002, while 30 or more years generate a monthly benefit of $617.00.

Limitations on Benefits

If you are simultaneously entitled to more than one Social Security

TABLE 4: **OASDI BENEFITS BY BENEFIT TYPE AND BENEFICIARY TYPE, WITH ELIGIBILITY REQUIREMENT AND BENEFIT SIZE**

Type, Beneficiary		*Worker's Insured Status*	*Benefit (as percent of PIA)*
Old-Age			
Worker	Retired worker, 62 or over	Fully	100*
Spouse	Retiree's spouse, 62 or over	Fully	50*
	Retiree's spouse, caring for worker's child under 16, or disabled child, if disabled before 22	Fully	50
	Divorced wife (in some cases if 62 or over and at least 10 years of marriage)	Fully	50
Child	Retired worker's child under 18**	Fully	50
Survivors			
Spouse	Widow(er) 60 or over (including surviving divorced wife in some cases), 50 if disabled	Fully	100*
	Widow(er) caring for deceased worker's child under 16, or disabled child, if disabled before 22	Fully or Currently	75
Child	Deceased worker's dependent, unmarried child under age 18,** or regardless of age if disabled before 22	Fully or Currently	75
Parent	62 or over	Fully	82.5***
Lump-sum death benefit	Spouse with whom deceased worker had been living, or spouse or child eligible immediately for monthly survivor benefits	Fully or Currently	$255
Disability			
Worker	Disabled worker under 65	Fully and Disability	100
Spouse	Disabled worker's wife, 62 or over	Fully	50
	Disabled worker's wife, caring for worker's child under 16, or disabled child, if disabled before 22	Fully	50
	Divorced wife (in some cases) of disabled worker if 62 or over and at least 10 years of marriage	Fully	50*
Child	Disabled worker's dependent, unmarried child under age 18,** or regardless of age if disabled before 22	Fully	50

*Reduction applies if benefit claimed before normal retirement age.
**Or if attending elementary or secondary school at age 18.
***If two parents, 75% each.
Source: Robert J. Myers, *Social Security,* 4th ed. (Philadelphia: Pension Research Council, Wharton School, University of Pennsylvania, 1993), p. 66, Table 2.3, and Yung-Ping Chen, *Social Security in a Changing Society,* 2nd ed. (Bryn Mawr, PA: McCahan Foundation, 1980), p. 37, Table 1.

benefit, only the highest benefit will be paid. For example, a woman entitled to an old-age benefit based on her own earnings record, and a wife's or widow's benefit based on her husband's earnings record, will receive only the larger of the two. She actually receives her own benefit plus a supplement to make up for the difference. Also, an eligible remarried widow(er) who remarried after age 60 can receive only the larger of the widow(er)'s benefit or the spousal benefit.

In addition, there is a Windfall Elimination Provision (WEP). This affects persons who receive both a pension based on noncovered work after 1956 *and* Social Security benefits. Pensions subject to the WEP include U.S. Civil Service Retirement System annuities, retirement benefits based on foreign earnings, and state and local government employee pensions based on noncovered earnings.

For the WEP to apply, eligibility for the noncovered-work pension and the Social Security benefits must begin after December 31, 1985. The WEP reduces the Social Security PIA for these persons and affects all their benefits except survivors. The WEP reduction remains in effect until entitlement to the noncovered pension ends, the wage earner dies, or the wage earner earns a total of 30 years of substantial Social Security earnings. The WEP reduction amount never exceeds one-half of the noncovered pension.

A WEP PIA is generally calculated with an initial AIME replacement rate of 40 percent (up to the first bend point) instead of 90 percent as with the regular PIA. If a worker has more than 20 years of substantial covered earnings, the WEP PIA starts rising. With the 21st year of such earnings, the first bend point percentage is increased by 5 percentage points. This rate of increase applies for each additional year of such earnings, through the 30th year, at which point the WEP no longer applies. Thus after 23 years of substantial covered earnings, the first bend point percentage would be 55 percent. After 30 years of substantial covered earnings, the first bend point percentage would be the normal PIA rate of 90 percent.

Taxation of Benefits: The Stealth Means Test

Benefits were long exempt from the income tax, the Treasury having ruled that for tax purposes, benefits were gratuities, i.e., gifts, and therefore not taxable. The 1983 Amendments introduced taxation of benefits. Specifically, they mandated including in taxable income up to one-half of the OASDI benefits for individuals whose "combined income," the sum of adjusted gross income plus nontaxable interest income plus one-half of Social Security benefits, exceeded $25,000 (if the beneficiary was single) or $32,000 (if married and filing a joint return).

In 1984, only 8-10 percent of retired households had incomes high enough to be affected by this change. But since the taxation thresholds are not indexed for inflation, as nominal incomes rise over time, an ever-increasing proportion of elderly beneficiaries will have their incomes pushed into the taxable range, until eventually most retirees will pay this additional tax. Assuming a "low" inflation rate of 3 percent, in 30 years $25,000 will be worth what $10,000 is today. This necessarily means that taxation of benefits amounts to means testing by stealth.

In 1993 Congress increased the maximum share of OASDI benefits subject to taxation, from 50 percent to 85 percent, for beneficiaries whose "combined income" exceeded $34,000 if they were single or $44,000 if they were married and filing a joint tax return. The additional revenue thus raised was directed to Medicare's Hospital Insurance (HI). Below these income levels, the old share of 50 percent of benefits remain subject to taxation.

By splitting "combined income" into intervals and taxing a larger share of benefits as "combined income" rises, the 1993 change increases the progressivity of benefit taxation and thereby, of course, increases its resemblance to a means test.

Financial Structure: A Ponzi Scheme

Social Security's FICA and self-employment taxes are collected by the United States Internal Revenue Service, and go into the Treasury's general revenue pool, commingled with revenue from all other sources (Federal income tax, excise taxes, etc.). Social Security's two Treasury accounts, the Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund, are then credited with an equivalent value of special unmarketable Treasury debt issued for this specific purpose. The Treasury pays Social Security benefits and debits these "trust funds" for amounts of these unmarketable Treasuries equal to the benefit outlays. Any remaining balance (i.e., any leftover stock of Treasuries) at the end of the fiscal year is Social Security's "surplus," the actual revenues having already been spent on general government operations.

Social Security is thus a "pay as you go" system, in which current revenues fund current costs. Your tax payments do not pay for your own benefits. Indeed, they cannot, since Social Security has no means of forward funding its future obligations. It cannot use your tax money to accumulate holdings of private stocks, bonds, and real estate that have market prices and therefore market value, and that can be realized for cash to pay your benefits. The Treasuries in the Trust Funds earn interest at the average market yield on outstanding marketable Federal securities not due to mature for at least four years from the date of determination, but interest

payments are made in the form of additional quantities of unmarketable Federal debt. Your tax payments, therefore, are used to finance transfer payments to current beneficiaries.

A pay-as-you-go system of transfer payments from the young to the old operates exactly like a Ponzi scheme. In 1919 one Charles Ponzi devised a bogus investment fund promising fantastically high returns. The first investors did indeed do well, but Ponzi had made no investments; he paid off the initial investors with money collected from the second round of investors, who in turn were paid off with money collected from the next round of investors, and so on. Eventually the pool of investors dried up, and the Ponzi investment scheme ended when Ponzi was arrested with $3 million in assets and $7 million in liabilities.

Not only is Social Security a Ponzi scheme on a national scale, it was so from the beginning. According to one estimate, a 65 year old man retiring in 1940 had paid in, through combined employee and employer contributions, enough money to fund a yearly retirement annuity of $6.59 (based on life expectancies at that time). But the average Social Security benefit paid out in 1940 to a 65 year old male was $270.60. Thus 97.7 percent of that benefit—$264.01—was a transfer payment from younger workers rather than a return of his actual contribution. Later generations of retirees paid more into Social Security, of course, but also received back far more than they paid, thanks to taxes extracted from younger generations, who correspond to the later rounds of investors in Ponzi's scheme, making their "investments" (tax payments) while young, then receiving their "returns" (benefits) from the next generation's "investments" (taxes). As long as the pool of new entrants and their incomes keeps growing faster than the payout obligations, benefits can be paid. Social Security's ability to keep paying benefits depends not on how well past contributions were invested (for they were not) but on the willingness and ability of the current workforce to pay taxes. This ability in turn depends on broad economic and demographic factors that determine the demand for benefits and the supply of taxes.

Social Security and Budget Accounting

Until the late 1960s the operations of the Social Security trust fund were not part of the general budget of the U.S. Government. Beginning in fiscal year 1969, however, Congress adopted a "unified budget" which combined all Federal revenues and outlays, including Social Security. This was done partly to give a more accurate measure of the total magnitude and economic role of Federal taxing and spending.

After the 1983 Amendments to the Social Security Act, OASDI began running substantial surpluses. These surpluses reduced the amount the

TABLE 5: **ON-BUDGET, OASDI, AND TOTAL FEDERAL RECEIPTS, OUTLAYS, AND SURPLUSES/DEFICITS (-), SELECTED FISCAL YEARS, 1985-2005**

(billions of dollars)

Item	*1985*	*1990*	*1995*	*2000*	*2005 est.*
On-budget receipts	$547.9	$750.3	$1,000.8	$1,544.6	$1,545.7
On-budget outlays	769.6	1,028.1	1,227.1	1,458.0	1,9353.1
On-budget surplus/deficit (-)	-221.7	-277.8	-226.4	86.6	-407.4
OASDI receipts	186.2	281.7	351.1	480.6	589.5
OASDI outlays	183.4	245.0	330.4	396.2	501.5
OASDI surplus/deficit (-)	2.8	36.7	20.7	84.4	88.0
Combined surplus/deficit (-)	-218.9	-241.1	-205.7	171.0	-319.4
Unified budget receipts	734.1	1,032.0	1,351.8	2,025.2	2,135.2
Unified budget outlays	946.4	1,253.2	1,515.8	1,788.8	2,343.4
Unified surplus/deficit (-)	-212.3	-221.2	-164.0	236.4	-208.2

Source: *Historical Tables, Budget of the U.S. Govt., FY 2004.*

Federal government had to borrow from the public to cover its revenue shortfalls. They also made the unified budget deficits of the 1980s and early 1990s much smaller than those years' large, chronic on-budget deficits.

The line "Combined surplus/deficit" in Table 5 isolates the difference the OASDI surpluses made in Federal budget accounting. The unified surplus/deficit figure is slightly different because miscellaneous other items such as the Postal Service are also counted as "off-budget" items, but it is clear by inspection that OASDI's surpluses usually played the decisive role in making the budget deficit seem smaller than it really was. Likewise, in the late 1990s, when the government began running relatively small on-budget surpluses, the Social Security surplus made the unified budget surplus much larger (see table entries for fiscal 2000). With on-budget deficits returning, the OASDI surplus is reverting to its role of unified budget deficit mitigation (see entries for fiscal 2005 estimates above).

Actuarial Analysis

By law, the Board of Trustees of the OASDI Trust Funds is required to report to Congress every year on the current and projected future financial status of the Trust Funds. The Board of Trustees' *Annual Report,* issued in March or April, contains detailed actuarial projections of Social Security's financial status over the short range, defined as the next ten years, and the long range, defined as the next 75 years. The latter period is chosen because it approximates the maximum remaining lifetime of current Social Security participants, including the youngest current taxpayers. Thus the 2003 report contained an actuarial analysis for the periods 2003-2012

(short range) and 2003-2077 (long range).

The actuarial analysis is based on the payroll tax rates and benefit formulas mandated by current law, and on assumptions by Social Security's actuaries regarding the future magnitudes of demographic and economic variables including the fertility rate (number of lifetime births per woman), mortality (death rates), life expectancy, the annual level of immigration, productivity (ratio of real Gross Domestic Product (GDP) to hours worked by all workers), the growth rate of real GDP, the unemployment rate, the inflation rate, average earnings, the growth of real wages, and the interest rate earned by the Treasury debt in the OASDI Trust Fund. The assumptions and methods used by the actuaries are reexamined every year in light of recent experience and new information about future conditions, and changed if revision is deemed appropriate.

Because projections of these factors and their interrelationships are necessarily uncertain, Social Security's actuaries use three different sets of plausible assumptions, designated as "intermediate" or "most likely" (Alternative II), "low cost" or "optimistic" (Alternative I), and "high cost" or "pessimistic" (Alternative III). The intermediate assumptions reflect the actuaries' best estimate of the outlook for the population and the economy. The estimates are not meant as precise predictions, but rather as indicators of a reasonable range for Social Security's likely future incomes and costs under a range of plausible assumptions. The actuaries anticipate that the actual future will be somewhere within the range bounded by the low cost and high cost analyses.

Using these analyses, the actuaries evaluate OASDI's future financial condition for both the short range (the next ten years) and the long range (the next 75 years). For the short range, the actuaries measure the OASDI Trust Fund's adequacy by comparing assets at the beginning of each year to that year's projected expenditures under the intermediate assumptions. If the trust fund ratio for each year is at least 100—i.e., if assets at the beginning of each year at least equal that year's projected outgo—the fund is deemed adequate to cover short-run contingencies.

For the long range, the main measure of OASDI's financial status for the period as a whole is the "long-term actuarial balance," the difference between (1) the summarized cost rate and (2) the summarized income rate. The summarized cost rate is the ratio of the sum of the present value of cost over the period plus the present value of the targeted ending trust fund level (100 percent of annual cost at the period's end), to the present value of taxable payroll for the period, expressed as a percentage of taxable payroll. The summarized income rate is the ratio of the sum of the trust

TABLE 6: **RESOURCE EXTRACTION THROUGH SOCIAL SECURITY TAXES, 1950-2002**
(dollar amounts in billions)

Fiscal year	OASDI tax revenue	Federal income tax revenue	Total federal tax revenue	Gross Domestic Product (GDP)	OASDI tax revenue as % of federal income tax revenue	OASDI tax revenue as % of total federal tax revenue	OASDI tax revenue as % of GDP
1950	$2.1	$15.8	$39.4	$273.4	13.3	5.3	0.8
1955	5.1	28.7	65.5	395.2	17.8	7.8	1.3
1960	10.6	40.7	92.5	518.9	26.0	11.5	2.0
1965	16.7	48.8	116.8	687.9	34.2	14.3	2.4
1970	33.5	90.4	192.8	1,013.2	37.1	17.4	3.3
1975	62.5	122.4	279.1	1,559.8	51.1	22.4	4.0
1980	113.2	244.1	517.1	2,732.1	46.4	21.9	4.1
1985	186.2	334.5	734.1	4,136.6	55.7	25.4	4.5
1990	281.7	466.9	1,032.0	5,735.6	60.3	27.3	4.9
1995	351.1	590.2	1,351.8	7,324.0	59.5	26.0	4.8
2000	480.6	1,004.5	2,025.2	9,718.8	47.8	23.7	4.9

Source: *Historical Tables, Budget of the U.S. Govt., FY 2004.*

fund balance at the beginning of the period plus the present value of scheduled tax income over the period, to the present value of taxable payroll for the period, expressed as a percentage of taxable payroll. If the long-term actuarial balance is zero or positive, then by definition the trust fund ratio at the period's end will be 100 percent or greater, and the program's financing is deemed adequate for the period.

The criterion for the long range is "long-range close actuarial balance." Using the intermediate assumptions, summarized cost and income rates are calculated for each of 66 valuation periods, the first being the next ten years, with each succeeding period becoming longer by one year, culminating in the full 75 years. OASDI is said to be in long-term close actuarial balance if for each of the 66 periods the actual balance is either zero or, if negative, by no more than a specified percentage of the valuation period's cost rate, rising from zero for the ten-year period to minus five percent for the 75-year period. For the past several years, the Board of Trustees has warned Congress that Social Security is not in long-term close actuarial balance.

The future income, cost, trust fund asset level, etc. projected by Social Security's actuaries are just that—projections. Although discussions of Social Security's outlook almost always treat these figures as exact, they are best thought of as ballpark figures or approximations. They may and probably will be wrong, they change every year, and they are only as good

TABLE 7: **SOCIAL SECURITY OUTLAYS, FEDERAL SPENDING, AND GDP, 1950-2000**
(dollar amounts in billions)

Fiscal year	*OASDI outlays*	*Total federal outlays*	*GDP*	*OASDI outlays as % of total outlays*	*OASDI outlays as % of GDP*
1950	$0.8	$42.6	$273.4	1.8	0.3
1955	4.4	68.4	395.2	6.4	1.1
1960	11.6	92.2	519.8	12.6	2.2
1965	17.5	118.2	687.9	14.8	2.5
1970	29.8	195.6	1,013.2	15.2	2.9
1975	64.2	332.3	1,559.8	19.3	4.1
1980	117.9	590.9	2,732.1	20.0	4.3
1985	183.4	946.4	4,136.6	19.4	4.4
1990	245.0	1,253.2	5,735.6	19.5	4.3
1995	330.4	1,515.8	7,324.0	21.8	4.5
2000	396.2	1,788.8	9,718.8	22.1	4.1

Source: *Historical Tables, Budget of the U.S. Govt., FY 2004.*

as the assumptions underlying them. Nonetheless, a rough indicator is better than none.

Social Security's Size and Importance

Initially modest in size, Social Security has become one of the largest features of our national landscape, thanks to repeated expansions and liberalizations and to the great growth in America's population.

In calendar 1950 (thirteen years after Social Security taxation started, ten years after benefit payment began), 48.2 million American workers were in occupations covered by Social Security, and 2.9 million Americans were receiving benefits. By calendar 2000, 153.5 million workers were paying OASDI taxes, and 45.2 million Americans were collecting benefits—38.6 million collecting old-age and survivors benefits, and 6.6 million getting disability benefits. At the end of calendar 2002, 46 million persons were receiving benefits: 39 million getting old-age and survivors benefits (32 million retired workers and their dependents, 7 million survivors), and 7 million getting disability benefits. An estimated 153 million workers paid payroll taxes.

As Table 6 shows, Social Security's tax has become a mighty machine for extracting resources from the private sector. In the fifty years from 1950 to 2000, Social Security taxes have almost quintupled as a share of Gross Domestic Product (GDP) and as a share of total Federal tax revenues. By 2000, almost one out of every four Federal tax dollars was raised by the Social Security tax, and the amount of revenue raised by the Social

Security tax was almost half as much as the amount extracted by the Federal income tax.

The imperative driving this soaring taxation, of course, is the growth of the benefit outlays that the taxes must finance. This has its roots in the repeated expansion of the program until eventually virtually the entire labor force participated; the liberalization in 1950 that reduced eligibility requirements to bring additional millions of elderly Americans under Social Security with minimal quarters of coverage; repeated increases in benefits; and the increase of America's population.

Table 7 depicts the explosion of benefits spending since 1950, in absolute terms and both as a share of total Federal spending and as a share of GDP. For every fiscal year beginning with 1993, Social Security has been the largest single item in the Federal budget. In fiscal 2002 Social Security accounted for 22.5 percent of Federal outlays, versus 17.3 percent for national defense and 8.5 percent for net interest on the national debt.

As the baby boom generation retires, Social Security's costs will of course be driven much higher still. Chapter III addresses this matter at greater length.

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