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AMERICAN SOCIAL CONTRACT: RETIREMENT, INSURANCE AND FINANCIAL VIABILITY

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Since the election of 2004, one burning question has dominated any discussion of the long-term macroeconomic policy of this country. That question is: "will social security remain viable in its current form?" Economists weigh in on a spectrum that ranges from the opinion that social security is not in any trouble to the opinion that social security payments are in immediate peril. This research indicates that, while relatively minor changes of the type the country has undertaken for the last two decades may be necessary, social security is by no means in what any intelligent analyst would consider peril.

INTRODUCTION

Among the premier issues of national concern in recent years, the debate over solvency of social security takes a prominent spot. From the appointment of the special commission to study the social security during Reagan administration to repeated surveys of the public opinion regarding issues surrounding the social security program, this is an issue that has captured imagination and interest of the American public. While few understand terminology like "trust fund" and even fewer understand the critical assumptions used by the Social Security Administration and the Congressional Budget Office in their calculations of the funds accumulated for the purpose of meeting the baby boomers' retirement needs, there is no shortage of opinions rendered regarding when those funds will run out.

It is particularly important that we remember why Social Security was started in the first place. The driver of the 1933 national debate on social security was poverty, and all the societal ills associated with deprivation. President Franklin D. Roosevelt, speaking to the issue of the deprivation of the Great Depression, warned the American public that we had "nothing to fear, but fear itself." Precious few of us alive today remember those "fireside chats" and the economic woes of the period that made those radio broadcasts such important landmarks in the political terrain of the day.

The generation who experienced those economic woes laid the groundwork for much of the opportunity enjoyed by the baby boomers and subsequent generations. The increased educational opportunities, establishment and protection of civil rights, and the so-called "entitlements" provided for a certain level of security for the members of American society heretofore never experienced.

The debate of the 1930s was focused on the provision of economic security for those who were unable to provide for themselves, and to assure those who reached retirement age that they would not be forced to live in poverty because they had inadequate resources for their retirement. Today, there has been a sudden turn away from these principles by which generations have lived. The once agreed-upon principle of providing for a modicum of security across society seems again to be subject to a renewed debate based on previously settled contentions. As we move away from the historic events that produced fundamental changes in the American way of life, we too often lose our institutional memory and forget what it was that caused these changes.

The issue was framed in a particular and correct way in the 1930s, and is now being subjected to revision that is left wanting in the face of the historic record, and economic evidence. There is a wide spectrum of views and conclusions drawn about the solvency of social security system. Some researchers firmly believe that the crisis is real and is, in fact, worse than is commonly thought (Attarian, 2002; Biggs, 2000; Feldestein and Samwick, 1996; and John, 2002). Others believe the crisis has been made up to advance some political agenda. These researchers and analysts argue that the social security system has no immediate financial crisis, that it will remain solvent for the next 30 to 40 years, and that the crisis is largely a "phony crisis" (Baker & Weisbrot, 2000; Cutler, 1997; and Skidmore, 1999). In fact, as of this writing, the Social Security Board of Trustees has continually deferred the estimated date of bankruptcy (Yang and Barrett, 2006).

In this bedrock of conflicting ideas, reform of the social security System was pronounced to be the centerpiece of President Bush's second-term domestic

policy agenda. Were Americans correct when they firmly rejected President Bush's plans or initiatives to "reform" the Social Security system? Did the nation miss a golden opportunity to fix a looming crisis in the future?

The purpose of this paper is to examine the contentions and assumptions that are being proffered in the current attempt to undue the "New Deal" legislation of the 1930s. In particular, the intent of the paper is to examine the data to ascertain whether future generations of Americans are facing a genuine Social Security crisis or if the so-called social security crisis is merely a manufactured one. Specifically, the paper seeks to examine the information to provide some answers to the above questions. The following section provides a background for the understanding of issues surrounding the Social Security system. Thereafter follows a discussion of social security finances and an analysis of assumptions used to make the bankruptcy predictions. The paper concludes with an exploration of the impact of proposed reform measures, policy implications and possible avenues for future research.

Background and Facts about Social Security

The Social Security or the Old-Age, Survivors, and Disability Insurance (OASDI) program was signed into law in August of 1935. Social security is an earned benefit program because only those who work and pay taxes for a certain period of time become eligible to receive benefits. It provides:

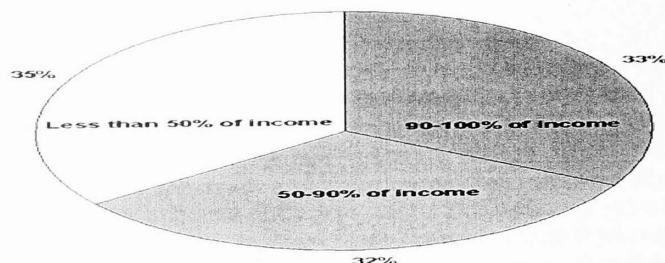
- Retirement benefits to workers, their spouses, and their dependents such as children and elderly parents. Workers can receive early retirement benefits if they reach the earliest age that retirement benefits can be

paid (currently 62) and they must have worked at least 10 years. Benefits, however, will be reduced by 20% relative to what the retiree would have received at the normal retirement age of 65. In 2002, 29.2 million retirees and 3.2 million spouses and children of retirees received benefits.

- Survivorship benefits to family members of a deceased worker. To receive these benefits, a worker must have worked, on average, at least one quarter for each year since he/she turned 21. In 2002, 6.9 million received survivors benefit.
- Disability benefits to workers who become disabled (physical or mental impairment) before their retirement. In 2002, disabled workers who received disability benefits numbered in 5.5 million and another 1.7 million were the spouses and children of disabled workers who received benefits.

The total number of beneficiaries has grown from 1.3 million in 1945 to 47 million (one in every six Americans) at the end of 2003. The average amount of benefits is tied to the worker's earning history. Because women tend to have lower life time earnings, they receive a lower average benefit. In 2002, for example, women received an average monthly retirement benefit of \$773.90 while men received an average monthly benefit of \$1,008.10. Furthermore, women are less likely to have pensions through their employers. In 2002, 44 percent of women and 47 percent of men had private pensions. For those women who do have private pension, it tends to be less because, relative to men, more women tend to work part time and spend some time out of the labor force. Thus, Social Security is particularly important to women.

Figure 1: Importance of Social Security benefits to those aged 65 and older



Source: EPI Issue Guide, Social Security, May 2005 Issue

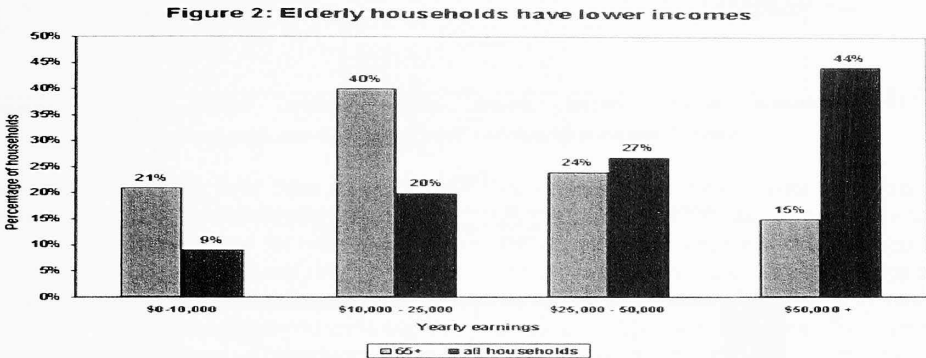
In addition, African Americans earn lower incomes in the course of work-life relative to whites and thus, will receive lower average monthly benefits. In 2002, the

average monthly retirement benefits for African Americans was \$779.80 and that for whites was \$911.70. Similarly, the importance of Social Security benefits to a

majority of the elderly cannot be exaggerated. Even though social security benefits are modest, they are the most important source of income for the majority of elderly households. Figure 1 above shows that, according to data collected by the Social Security Administration in 2001, Social security benefits accounted for over half of income for sixty five percent of elderly households (65 years or older), and for one-third of these households the benefits were 90 to 100 percent of their income.

The importance of social security benefits to elderly will be appreciated when considering that the elderly

households, in general, have lower income relative to the rest of population. Figure 2 shows that while only 9% of households had an annual income of \$10,000 or less, this percentage for the elderly was more than double that percentage or 21%. Also, 40% of the elderly had incomes in the range of \$10,000 to \$25,000 while half that or 20% of other households had incomes in this range. The opposite is true at the high end of the income distribution where only 15% of the elderly enjoy incomes of \$50,000 or more relative to 44% for the other households.



Source: EPI Issue Guide, Social Security, May 2005 Issue

Financing Social Security

To realize when the system might become bankrupt, it is important to understand that the social security trust fund is like a bathtub. The outflows from social security funds are straightforward and consist of payments to beneficiaries. An understanding of the inflows, on the other hand, is not as straightforward and is the source of much of the misinformation surrounding this issue.

Sources of funds that the social security system draws upon can be considered as three separate elements. One is the money paid in payroll taxes by current employees and employers (6.2% each). The second consists of interest earned on the surplus built up in the social security trust fund. The 1983 Social Security Commission, chaired by Alan Greenspan, deliberately designed a system that would build up a surplus by taxing more than was necessary to pay benefits (Baker, 2006). This money has been borrowed by the U.S. government and the assets now exist in the form of government bonds. That is the surplus is being invested in non-tradable government bonds. In 2003, the effective annual interest earnings of all bonds held in the trust fund were about 6% (EPI, 2005). The federal government is naturally obligated to

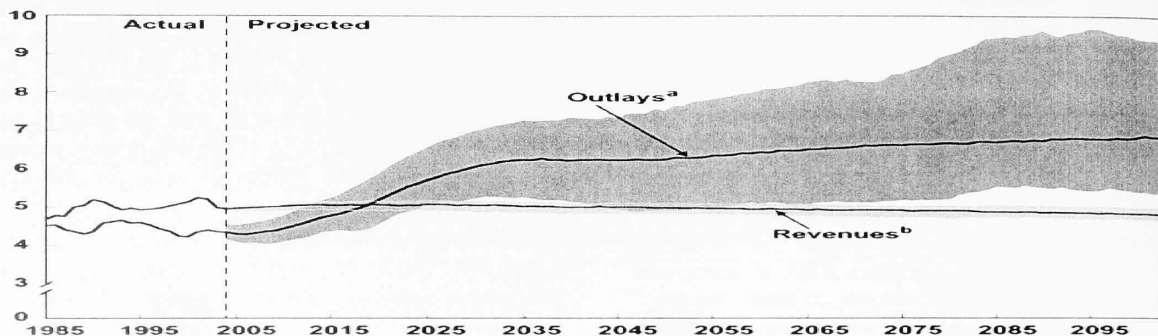
repay these bonds which leads to other economic questions, but not to uncertainty for the social security trust fund. The third entity is the amount of funds that have been accumulated in the trust fund itself.

There are then three time periods that become of interest in any analysis. One period of time that will be important in planning for the possible “crisis” is the date when the outflows exceed the money coming in from current employees and employers’ payroll taxes. The second date of interest is the time at which the outflow exceeds this income plus the interest income earned on the trust fund accumulation. The third is the date at which the trust fund accumulation (designed to allow for the retirement of the Baby Boomer generation) is exhausted. Since, by current law, these programs are not allowed to borrow, this is the date at which the social security account will no longer be able to pay anything approaching current payout levels.

If one is considering the first scenario in which outflow exceeds the income paid in by current employees and employers (the theory behind the pay-as-you-go system), then the consensus is that the funds will run out sometime in between 2016 and 2022 (Congressional Budget Office (CBO), 2001 and Social Security

Administration, 2005). This can be seen graphically in figures 3 and 4 below. In figure 4, while the focus of this paper is retirement benefits, the situation for disability insurance is analogous to that of OASI.

Figure 3: Income, Outlays and Balances of the Social Security Trust Funds 2001 to 2037



Source: Congressional Budget Office, Social Security: A Primer, September 2001

Figure 4

Long-Range OASI and DI Annual Income Rates and Cost Rates
[As a percentage of taxable payroll]
Source: 2005 OASDI Trustees Report

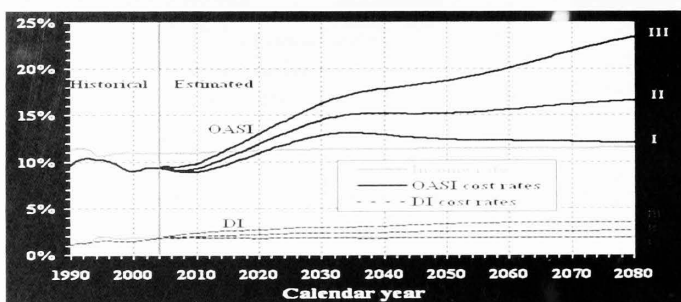
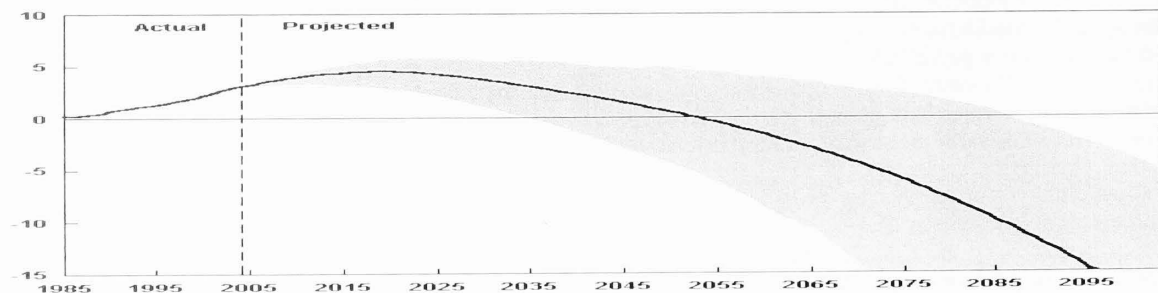


Figure 5: Trust fund ratio projections



Source: CBO, 2001

If, however, one considers the interest income from the social security trust fund, then the date of the crisis is extended to sometime in the late 2020's (CBO, 2001). If we look at the date when all funds are exhausted and

payments to retirees would cease, then we are interested in the date when all three assets go toward zero (since the system would presumably continue to tax current workers and employers, it would not be completely depleted). This can be seen in the following two figures, which look at the trust fund ratio. The trust fund ratio is a useful indicator of the adequacy of the financial resources of the social security program at any point in time. In the year that the trust fund ratio becomes negative, the program

will no longer be able to cover the full amount of benefits for that year under the current law (Social Security Trustees' Report, 2005). Figure 5 above shows projected estimates for the trust fund ratio.

Most studies are based on the trustees' reports. Since the trustees have reported a shortfall in 35 years, we have gone back to their historical records for the years noted to check the accuracy of their forecasts. These results are reported in table 1.

Table 1: Analysis of the Accuracy of the OASDI Trustees' Forecasts for the Trust Fund Ratio

	Forecast	Actual
1945/1980	.9	.24
1950/1985	.74	.24
1955/1990	1.16	1.76
1960/1995	2.31	1.26
1965/2000	1.52	2.00

It must be noted that there have been a number of accounting and reporting changes that make this difficult, but a cursory analysis reveals that the trustees, in the three most recent time periods analyzed, over predicted once and under predicted twice. Also, the mean sum of square of .69 (large by trust fund standards) indicates that this is far from an exact science. A simulation using a variety of measures for economic growth, increases in productivity and demographic changes is warranted and is mentioned in the conclusion as an avenue of future research.

The Congressional Budget Office predicts that the trust fund assets will be exhausted in the year 2052 (with 80% certainty). A number of independent researchers have reached similar conclusions (Clark, 2004 and Tempelman, 2005). The growth rates used in these studies are crucial to the accuracy of the estimates. A simulation using varying assumptions for these growth rates is a suggestion for future research on this topic. Clearly, we should be mindful of the fact that these funds can and will be exhausted. However, forty years from now the economy and, in fact, the world will be a very different place.

CONCLUSION

When considering the financial situation of retirees and employees in the years beyond 2052, one is reminded of a couple of quotes by famous economists reflecting on the analysis of long run macroeconomic issues. The first is Robert Solow who asked why current generations should be asked to sacrifice for future generations who will no doubt be made better off by technology (paraphrased) (Solow, 1985). The second, perhaps more

famous, quote is by John Keynes who made the profound announcement that, "in the long run, we are all dead." Over the past years since the Social Security Act has been enacted, we have faced a number of crisis periods in its history and responded with a number of measures such as delaying COLA and, perhaps the greatest change, gradually raising the age at which retired workers could receive full benefits. No doubt, when the time comes, future voters will be called upon to make these difficult decisions. In a recent paper, economists James Hines and Timothy Taylor propose that, "the longer the U.S. political system waits to address the long-run insolvency of social security, the more severe are the changes that will be required" (2005: 9).

In the same issue of the *Journal of Economic Perspectives*, a number of economists propose a variety of remedies for the crisis. Among these are tax increases, benefit reductions and the creation of individual accounts (Feldstein, 2005 and Diamond and Orszag, 2005). Another suggestion involves a calculation of benefits by shifting from wage indexing prior earnings to price indexing them after 2009 (Pozen, Schieber and Shoven, 2004). The costs and benefits of each of these proposed methods of reform require careful consideration. As a suggestion for future research, one might weigh these costs and benefits with respect to each of the at risk demographic groups considered in this paper. These groups were those that Social Security was intended to help and, therefore, these groups should be considered foremost with respect to changes in the social security system (Wray, 2006).

Social security, which is recognized as one of the most successful anti-poverty social programs in spite of

some critics' dire warnings, is not in danger of going bankrupt. Claims of the social security system being in "crisis" are equally suspect. Currently, the nonpartisan Congressional Budget Office does not project a shortfall until 2052. Perhaps, the wisdom of American people, in aggregate, is confirmed when they rejected the assault on social security as a pillar of the American way of life. To paraphrase Samuel Clemens, "the reports of social security's demise have been highly exaggerated."

Further avenues of research in this area include an analysis of the effects of the proposed reforms on various societal groups and an analysis of the assumptions used to generate the data contained in this report. Also, while the social security crisis may be averted by the implementation of fairly palatable changes to the existing system, the looming healthcare crisis is most likely not. While an analysis of the healthcare crises is beyond the scope of this paper, we note it here as a long-term macroeconomic crisis at least as worthy of economists time and attention as the Social Security crisis.

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