



Social Security Choice

SOCIAL SECURITY THIS WEEK

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Social Security Actuaries: Raising the Cap Is Not a Permanent Solution

The Social Security Administration this week published a memorandum on an analysis on the effects of increasing the maximum taxable Social Security wages. Several opponents of individual accounts have suggested to raise or eliminate this cap thereby adding years to the system's solvency. However, the results of the analysis conclude that eliminating the cap is not a permanent solution. Thus, individual accounts remain the only actuarially scored solution that promise to bring Social Security to solvency.

The memo provides analysis of two proposals.

Under Proposal 1: "the contribution and benefit base would be eliminated for earnings in years after 2003, for both the purpose of computing payroll tax and for setting limits on the amount of earnings credited in OASDI benefit computations. For example, a worker with covered earnings of \$200,000 in 2004 would pay employee payroll taxes of \$12,400 (more than double the amount under current law, with a similar increase for the employer), but would also be credited the total \$200,000 as 2004 earnings when determining OASDI benefits. The worker's benefits would be higher than under present law."

The memo estimates that the financial effect of such proposal would delay permanent cash deficits by only six years—from 2018 to 2024. In 2078, the increased revenue would still only be enough to fund 74 percent of promised benefits.

Under Proposal 2: "the contribution and benefit base would become a benefit base only. The base would be eliminated for the purpose of computing payroll tax, but would continue to be used to set limits on the amount of earnings credited in OASDI benefit computations. For example, a worker with covered earnings of \$200,000 in 2004 would pay employee payroll taxes of \$12,400 (more than double the amount under current law, with a similar increase for the employer), but would only be able to credit about \$87,900 as 2004 earnings when determining OASDI benefits. The worker's benefits would be the same as under present law."

This alternate proposal eliminates the cap on taxable wages and, further, denies any benefits based on these additional contributions. Such measures would alter the relationship between contributions and benefits for high-income earners. Essentially, Social Security would no longer resemble a contributory insurance system. Even under this “stick it to the rich” proposal, permanent cash deficits would begin in 2025—delayed 7 years.

While both proposals extend Social Security’s insolvency date, eliminating the wage cap is by no means a permanent solution. As the memo states, “under both proposals, the trust fund ratio is decreasing at the end of the long-range period.”

Thus, certain individual account proposals for Social Security remain to date the only actuarially sound solution to permanent solvency, without mass tax increases.

Social Security’s Future Needs Investment and Liability Recognition

The latest Federal Reserve Bank of Dallas issue of *Southwest Economy* claims that Social Security has below market returns and a \$10 trillion “closed group liability.” In their paper “[Social Security Restructuring: Tough Decisions Ahead](#),” senior economists Jason L. Saving and Alan D. Viard suggest that private investment must be coupled with recognition of the unfunded liability.

“In recent years, talk of Social Security restructuring has grown because the system offers many current and future workers below-market returns. This means they will retire with less income than they would have had if Social Security had never been established. Some have suggested that workers be allowed to deposit some or all of their Social Security contributions into individual retirement accounts.

“Many people believe Social Security provides below-market returns because it is not just a pension program—it also, for example, redistributes resources from high-wage to low-wage workers. ...These monetary transfers from one worker to another do not change the rate of return achieved by the generation as a whole and have nothing to do with Social Security’s low returns.

“The below-market returns paid to current and future workers are directly caused by the fact that Social Security is (largely) a pay-as-you-go system. ... In other words, each generation’s retirement is financed by the contributions of its children rather than its own past saving. Such a system accumulates no assets; it is merely a sequence of transfer payments from young to old.

“In the first period, the generation that is then retired enjoys a financial windfall, or start-up bonus, because it receives benefits without having contributed to the system. Pay-as-you-go Social Security is an exceedingly good deal for this first generation. ... For example, the first recipient, Ida May Fuller, paid \$25 in taxes but received \$22,889 in benefits over her lifetime.”

“But later generations do not enjoy this windfall because they must pay for their elders’ retirement before receiving benefits. ... Having bestowed above-market returns on earlier participants, a pay-as-you-go system lacks the resources to give market returns to later participants. The losses suffered by later generations are the price of the bonuses paid to the earlier generations.

“The rate of return each generation receives from the system can be computed from the generation’s payment to its parents and the payment it receives from its children. Whether Social Security is a good deal for each generation depends on how its return from the system compares with the return it could have earned through capital accumulation.

“What has that growth rate been in the United States? From 1929 to 2002, total labor income (adjusted for inflation) grew at an average rate of 3.4 percent per year. A 3.4 percent real return may seem like a good deal, but it’s not. If workers weren’t paying into Social Security, they could accumulate capital and earn a return that averages around 6 percent per year (adjusted for inflation).

“In any given year, the difference between 3.4 percent and 6 percent is not very large. But it is quite large when compounded over a lifetime. The lower return cuts the retirement benefit roughly in half. So a generation that faces a constant tax rate throughout its lifetime suffers a net loss from the pay-as-you-go system equal to about half its tax payments.

“[A low birthrate] imposes a significant strain on pay-as-you-go Social Security. Slowing the growth of the working population causes U.S. labor income to grow at a slower rate than it otherwise would, further pushing down the system’s returns.

“Every pay-as-you-go system has a ‘closed-group liability’ that is equal to the benefit promises for which no assets have been accumulated. This liability measures the present value of the burden future generations must bear through below-market returns. ... The closed-group liability of the U.S. system is enormous—about \$10 trillion, or a year and a half of the country’s labor income.

“To forestall this grim outcome, many analysts have proposed a system in which each generation finances its own retirement. Such a system would allow workers to earn market returns on their contributions, boosting their retirement income.

“The inescapable reality is that the pay-as-you-go system has promised benefits to current retirees without accumulating any assets to pay them. If the current system is maintained, every future generation must bear below-market returns to service this liability. If the system is shut down, some generations must bear a large transition cost to pay off this liability. Every subsequent generation, freed from the obligation to pay for its predecessor’s retirement, could then earn market returns by accumulating capital.

“There may be sound reasons to support [individual accounts] but neither it nor any other reform can eliminate below-market returns unless and until the closed-group liability has been paid off and each generation pays for its own retirement. No plan to eliminate below-market returns can sidestep the need for \$10 trillion of tax increases or spending cuts.”

Costello on Fox News

Absent structural reform, it is widely known that Social Security promises insolvency, requiring massive payroll tax increases, benefit cuts, or both. Yet as the Democratic primaries begin to take shape, the presidential candidates have yet to address the seriousness to Social Security reform, or the adequacy of individual

accounts as a solution. The following *Fox News* op-ed by [Social Security Choice.org](http://SocialSecurityChoice.org) president Robert Costello asks, “Social Security: Where Do the Candidates Stand?”

“With the 2004 presidential primary elections fast approaching, voters should know where the major candidates stand on a critical issue: Social Security choice.

“Millions of Americans know that Social Security is in trouble. With the ratio of workers to retirees narrowing, the nation’s largest and most popular program will be unable to maintain its current benefit level for retirees without running huge deficits or significantly raising taxes on workers.

“To avoid this scenario, most financial experts support moving to a funded system that allows workers to invest a portion of their Social Security taxes into personal retirement accounts (PRAs). Such accounts would be highly diversified and would create new wealth that would head off the problem before it arises.

“Let’s examine the position of each of the major presidential candidates on the PRA option.

“According to the *New York Times*, Gov. Howard Dean (D-VT), said in 1995 that he ‘absolutely’ believed in raising the Social Security retirement age to address the looming insolvency of the system. Now, however, Dean proposes raising the cap on taxable wages to pay future Social Security benefits.

“But raising the cap (a tax increase) only buys us a few years to insolvency while PRAs will permanently solve the problem. Liberals like Dean should instead support Social Security choice, as low-income individuals would greatly benefit from owning and building real wealth in their personal accounts.

“Retired Army General Wesley Clark hinted in a recent debate that he might be open to the idea of PRAs, but also said we need to ‘fix Social Security first’ before allowing for private investment options.

“As a new entrant into the Democratic race, Clark may be excused for being vague, but the only real way to fix Social Security permanently is by building real savings through PRAs. Voters must insist he take a clear stand for the personal accounts before supporting his candidacy.

“Sen. John Kerry (D-MA), has been outspoken about his position on the issue. Unfortunately, he’s on the wrong side of it. Kerry has said, ‘We must uphold the promise of Roosevelt, Truman, Kennedy, Johnson, Carter, and Clinton and never allow the President and his Republican friends to threaten Social Security by putting it on the Wall Street trading block.’

“Perhaps the good Senator doesn’t understand the real threat to Social Security isn’t the ‘Wall Street trading block’ but the dwindling number of workers to retirees—or perhaps he’s simply engaging in demagoguery.

“In the 1990s, Sen. Joe Lieberman (D-Conn.), suggested he’d be willing to consider the idea of personal accounts. Then he became Al Gore’s running mate in 2000 and hastily repudiated the idea as a ‘risky scheme.’

“That brings us to President George W. Bush. In his 2000 campaign, Bush proposed allowing workers to invest a portion of their Social Security taxes into PRAs

and has continued to voice support for the idea. Nevertheless, he has yet to actively push for reform of the current system.

“It’s important for voters to understand that America’s changing population makes Social Security reform inevitable. The only question is: will we quickly enact positive reform like PRAs instead of waiting until the last minute to cut benefits or hike taxes?”

“That’s a question any presidential candidate should clearly answer in the affirmative before voters give him their support.”

Accounts Would Settle Gay Union Benefit Disputes

Tangents of debate on legal unions for same-sex relationships further illustrate the fairness of individual retirement accounts, specifically in regards to inheritable survivor benefits. A *New York Times* [article](#) reports of a surviving partner whose child was denied Social Security survivor benefits because the union was not considered legal.

“Eva Kadrey and Camille Caracappa had been a couple for five years before they decided to have a family together,” writes columnist Maria Newman. “With the help of an anonymous sperm donor, Ms. Kadrey became pregnant. The couple named him Nicolaj, after Ms. Kadrey’s father.

“In October 2000, Ms. Caracappa, an oncology nurse, died of a brain aneurysm at age 38. The following month, with the support and urging of Ms. Caracappa’s mother, Ms. Kadrey—who had been a stay-at-home mother to her son—applied for Social Security survivor benefits for Nicolaj.

“But the Social Security Administration denied the request, saying that the child did not meet the agency’s test as Ms. Caracappa’s legal survivor. The two women were not legally married, as New Jersey law does not allow same-sex marriages, and Ms. Caracappa was not Nicolaj’s biological mother.

“But Ms. Kadrey and her partner’s family say that the two women and their son were a family, even though one not recognized by the law, and that Nicolaj is as entitled to Ms. Caracappa’s Social Security benefits as any other child whose parent dies. A lawyer for Ms. Kadrey has appealed the decision to an administrative law judge for Social Security, and they are awaiting a ruling.

“Meanwhile, the American Civil Liberties Union has filed a friend of the court brief on behalf of Nicolaj, saying the matter would not be in dispute if same-sex marriages were allowed in New Jersey, where the two women lived when Ms. Kadrey gave birth to Nicolaj.

“John Shallman, a spokesman for the Social Security Administration in the New York regional office, said the agency looks to state laws to determine who is eligible for survivor benefits. While he would not speak of this case specifically, he said that federal regulations say that a survivor is a minor who is dependent on the deceased person, and who is considered an heir to the deceased person’s property. ‘We are bound by state laws on the definition of marriage and legitimate heirs.

“Ms. Kadrey, who now lives in Manhattan with her son, said that while the benefits would help her financially, she is more upset at what the denial says about her decision to raise a family with Ms. Caracappa.

“‘To have some government agency come in and say Camille was not his mother was very upsetting,’ Ms. Kadrey said. ‘He has her last name, not mine. He was baptized in the Catholic Church, because her family is Catholic, I am not. It was hurtful to everybody.’

“She added, ‘I just want Nicolaj to get what is rightfully his.’”

A larger solution to these problems is to incorporate personal retirement accounts into Social Security. Personal accounts create a clear property rights for individuals in which they can bequeath contributions to their family members, regardless of state or federal legality of their union.

Tweaking only Postpones the Inevitable Need for Investment

Following-up from her last *Tech Central Station* [article](#) in which columnist Megan McArdle depicted the stagnating effects of massive entitlement programs, she now writes about what measures would be necessary to stabilize the declining worker-to-beneficiary ratio. Her column, “[Demography, Disaster and Destiny](#),” points out that these are temporary fixes. What workers, retirees, and a shrinking workforce needs are investments.

Social Security starts running a deficit in 2018. She writes: “When that happens we’ll be faced with four options: cut benefits, raise taxes, cut other spending, or borrow money (which itself only defers the need to do one of the first three.) But all of these options are so *unpleasant*. Isn’t there some other way?”

“To understand exactly why Social Security is so troubled, it’s helpful to stop thinking about our looming fiscal crisis, and think instead about the demographic problem that’s causing it. For all the exhaustive arguments about tweaking benefit levels, changing the structure of FICA, or raising taxes, the main problem with Social Security is devastatingly simple.

“While there are currently 3.3 workers in the workforce supporting every retiree, in the 2040’s—when the Social Security Administration’s projections show the program falling off the cliff into insolvency—there will be fewer than 2, due to a combination of falling birth-rates and longer life-spans. Any long-term solution, therefore, must do one of two things: increase the ratio of workers to retirees, or increase the productivity of the workers so that they can support themselves and the retirees depending upon them.

“Changing the ratio of workers to retirees is probably easier. Increasing the number of workers, indeed, could be a lot of fun; the most obvious way to do it is to make more babies. Barring that, we can import more workers.

“But while opening up the floodgates to immigrants who can staff our old-age homes and geriatric wards while shoring up our retirement funds may be necessary, it will not be sufficient. ... Birth-rates are falling everywhere, not just in America; as developing economies improve, and their populations begin to level off, the supply of immigrants will eventually dry up.

“If we can’t increase the size of the workforce that much, what about shrinking the number of retirees? ... Pushing up the age at which people leave the workforce is less politically attractive, but more effective. People are living longer and healthier lives than ever; there’s no reason that a medically advanced post-industrial society should cleave to a retirement age set in an era when most people made their living by grueling manual labor. We can almost surely raise the retirement age to 70 with minimal problems—except, of course, for the mob of angry seniors marching on Washington.

“At some point, however, this strategy will cease to work. Medical advances will likely continue to expand life-spans, even as birth-rates keep dwindling. How far can we raise the retirement age? 80? 90?

“At this point, you may be wondering—if the shrinking workforce is such a problem, what does that mean for privatization schemes, like the one President Bush proposed for diverting 2 percent of a worker’s income from the Social Security system into private accounts?

“[Private investment] will be a major component of any long-term solution to the Social Security crisis. Why? Because private accounts increase our national savings. Unlike money given to the government, which overwhelmingly goes into current spending, money invested in the private sector is used to do new research, invent new products, and buy new facilities and equipment—all of which will eventually make our future workers more productive. When we’ve gone as far as we can go towards changing the ratio of retirees to workers, privatization can take us the rest of the way by increasing the output of the workers we have left so that both workers and retirees can continue to live in comfort.

“But privatization is *expensive*, say those selfsame advocates. And there they have a better argument; while privatization will be effective, it will not be painless. Andrew Biggs of the Cato Institute estimates that the kind of really ambitious program we want—one that reserves 5 percent of a worker’s salary (out of the 12.4 percent payroll tax)—would increase the unified budget deficit by approximately \$200 billion a year for the next 40 years. That’s 2 percent of GDP, a big number, though the other elements of reform I’ve discussed—means testing, raising the retirement age, and increasing immigration to grow our labor pool—could lower it substantially.

“Morally, I’d say the choice is clear. But pragmatically, too, it behooves those of us who plan on sticking around for a while to invest in the future. Otherwise, we risk being among the dancers who get crushed when Social Security finally falls over the cliff.”

Publications

American Enterprise Institute: Karlyn H. Bowman addresses the issue of Social Security in the latest in a series of AEI Studies in Public Opinion. “[Attitudes About Social Security Reform](#)” compiles results polls conducted by Roper ASW, Gallup/CNN/USAToday, Yankelovich, Fox News/Opinion Dynamics, Washington Post, Harris Teeter, CBS/New York Times, ABC News, L.A. Times, Zogby International and others. Bowman collects opinions on Social Security into categories of Confidence in

Social Security and Other Sources of Retirement Income, Attitudes Toward Reforms, Politics, Personal Investments, Stock Market Risk, and Investment Plans.

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