

Social Security Privatization

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The Trust Fund, the Surplus, and the Real Social Security Problem

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Executive Summary

Recent discussions of Social Security's future solvency have been dominated by misleading and inaccurate portrayals of the Social Security Trust Fund and the impact of budget surpluses on the program's finances.

In reality, the Social Security Trust Fund is an accounting measure, not an accumulation of real assets that can be used to pay future benefits. That means current discussions of Social Security "lock boxes," or whether the Social Security "surplus" is being "raided," are essen-

tially irrelevant to the program's future. The federal government lacks a mechanism that would allow it to save today against the future demographic and financial pressures that will make Social Security's current structure unsustainable over the long term.

Congress should stop playing verbal games over what are essentially accounting gimmicks and begin the serious project of Social Security reform. Ultimately, that reform will have to involve allowing workers to privately invest a portion of their Social Security taxes through individual accounts.

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Introduction

Yes, there are real problems with the Social Security system. No, the problem is not that we may raid the trust fund next year or that we have failed to provide a “lock box” to save the surplus. The real problem is very different. Social Security is essentially funded on a pay-as-you-go basis, meaning that the benefits of current retirees are paid by the taxes of current workers. As a result, the system is a potential “victim of demography.”¹ Indeed, demography will turn against the system in the not-too-distant future when the baby boomers start to collect benefits. It will be tough to pay the bills because we have promised large and growing benefits but have not created any viable mechanism for prefunding those benefits.

Worrying about the size of the trust fund is misguided. It is a fund in name only; it holds no real assets. Consequently, it does not generate funds to pay future benefits. And there are other problems. Social Security discourages saving and distorts work incentives, negatively affecting income in old age and national income in general. Despite its huge expenditures, it has not eliminated poverty among the elderly.

The pundits tell us that Social Security is the third rail of politics. But it is difficult even to hold a dialogue on the subject because the operations of the program are so cloaked in complexity that the public is confused about the true nature of the program.

What Is the Trust Fund?

The phrase “Social Security Trust Fund” creates the illusion that it is an investment fund with tradable economic assets that can be held until needed to pay the benefits of future recipients. But in reality the fund functions only as a mechanism for tracking Social Security revenues and outlays, each year recording the difference between Social Security tax collections and payments to current beneficiaries. In most years receipts have exceeded benefits, creating a “Social Security surplus.” (In the years since 1937, when the Social Security program began to operate, it ran deficits in only 14 years—8 of which occurred during the period 1975–1983.) The surpluses are credited as net additions to the trust fund. On paper, the reserves that accu-

mulate in the trust fund are recorded as investments in special Treasury bonds and collect interest that is also recorded as an addition to the fund. However, those investments do not provide the government as a whole with additional resources, as is the case when a private individual pays taxes. The investments are merely records of transfers from one part of the government to another.

To understand the process, one must recognize that Social Security is not an entity separate from the government in any real sense. Rather, it is an intrinsic part of a unified federal budget. Operationally, payroll tax receipts for Social Security are intermingled with income taxes and other federal revenues; Social Security benefits are a part of total federal outlays. When the non-Social Security part of the budget is in deficit—meaning that revenues other than Social Security taxes fall short of non-Social Security outlays—budget surpluses in Social Security automatically cover the gap. Moreover, that situation has been the norm in most years.

Over the last 40 years the non-Social Security part of the budget was in deficit in every year except 2—1999 and 2000. In most years the Social Security surplus was not large enough to compensate for the deficit in the non-Social Security side of the budget. Thus, of the past 40 years, the unified federal budget was in deficit in all but 5 years: 1969 and 1998–2001. The Congressional Budget Office (CBO) estimates that the unified budget will eke out tiny surpluses in 2002 and 2003, assuming that policy affecting the budget is unchanged.² But the non-Social Security side of the budget is expected to return to its more usual condition of running deficits through 2009 even with no new spending.

At the end of fiscal year 2001, the accounts for the combined OASDI trust fund (containing both the Old-Age and Survivors Insurance and the Disability Insurance funds) recorded assets of more than one trillion dollars. However, those so-called assets simply reflect the accumulated sum of funds transferred from Social Security over the years to finance other government operations.

What happens when Social Security taxes fall short of Social Security benefit payments? Because the trust fund does not hold assets that can be sold to pay current benefits, the federal

government must acquire additional resources to make good on the commitment to pay benefits. The current pay-as-you-go system allows for acquiring these resources through a tax hike, a reduction in other government expenditures, or borrowing from the public. Social Security benefits can also be reduced in the short run, for example, by postponing a cost-of-living increase or in the longer run by modifying the formula for determining benefits or increasing the age of retirement. The condition of the economy and the total budget obviously would influence the decision. But so would the prevailing political winds. Pay-as-you-go is not risk free.

Current projections of the Social Security actuaries indicate that Social Security payments will begin to exceed Social Security taxes around 2016—a consequence of the surge in beneficiaries that is expected as baby boomers retire in large numbers. Although the actuaries do not expect the trust fund to be exhausted until 2038, the date of practical significance is clearly 2016. That is the year in which Social Security will become a current liability to the budget and the government will be compelled to take measures to find the extra funds needed to cover benefits. At that time, the trust fund is projected to hold about five trillion dollars in reserves. However, as noted, those reserves hold no assets that can simply be cashed to pay the bills. With or without the trust fund, the government must acquire additional resources from taxes, borrowing, and the like in order to cover a Social Security deficit. The existence of the trust fund in no way eases the real cash-flow problem.

And yet some argue that in a broad economic sense the Social Security trust fund should be viewed as a way to pre-fund Social Security benefits. For instance, four of the most prominent defenders of the current system—Henry Aaron, Alicia Munnell, Alan Blinder, and Peter Orszag—state, “The accumulation of trust fund reserves raises saving, reduces the public debt, and thereby reduces the annual cost of paying interest on that debt, and promotes economic growth.”³ Presumably such a favorable chain of events would make it easier to pay obligations in the future when Social Security payroll tax receipts are projected to fall short of benefit payments.

That argument, however, is based on assumptions about the behavior of policymak-

ers and of the economy that are highly speculative. For one thing, in order for the Social Security surplus to have any chance of increasing saving, it must reduce the total (unified budget) deficit or increase the total surplus if a surplus already exists. But history has shown that Social Security surpluses have, if anything, led to more spending, not saving. As demonstrated by Kent Smetters, a leading economist and Treasury Department official, surpluses in the Social Security accounts have enabled the non-Social Security side of the budget to spend more and run larger deficits than otherwise would be the case.⁴ Moreover, even if politicians were able to resist the siren song of a Social Security surplus and simply allow such a surplus to reduce the overall deficit, the effect on saving and economic growth would be uncertain. And beyond that there is no way to guarantee that any fruits of economic growth reductions or both in the publicly held debt would be turned over to Social Security by future legislators. (See below for further discussion of this point.)

In sum, Social Security surpluses that accumulate as reserves in the trust fund do not build real assets that can be counted on to fund future shortfalls, either directly or indirectly. The surpluses, however, are a source of current revenue for the government to use for whatever purpose seems most pressing at the time. It would be difficult if not impossible to determine whether the use made by the government of the surpluses has made it easier or harder to pay the benefits of future beneficiaries.

Why then does the Social Security program have a trust fund? It was established by the 1939 amendments and, as John Cogan, an economist with the Hoover Institution and a member of the President’s Commission to Strengthen Social Security, put it, it was “a labeling device designed to provide political protection against the charge that the funds were being misspent.”⁵ It is a misleading label, however, and gives workers the false sense of contributing to an account held for them in a fund. When in fact there is only a record of how much the government has borrowed from future recipients. The trust fund may help back up a promise that funds will be raised to pay benefits in the future when deficits occur. But depending on conditions of the day, keeping that promise may not be possible.

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The Financial Outlook for the Current System

During the 1990s the Social Security accounts developed a sizable surplus partly due to a slowdown in the growth of new beneficiaries as the low-birth cohorts of the late 1920s and 1930s reached retirement age. A rise in the tax rate at the start of the decade, low unemployment, and rising wages also contributed, although the acceleration in wage growth eventually will put added strain on the fiscal balance of Social Security as higher earnings are translated into higher benefits.⁶ By fiscal year 2000 the Social Security surplus had grown to \$152 billion, or 1.5 percent of gross domestic product (GDP). The surplus increased to \$163 billion in 2001, even as the surplus in the non-Social Security part of the budget faded. The Congressional Budget Office projects the Social Security surplus will continue to increase over the next decade, reaching more than \$300 billion in 2011.⁷

However, the demographic factors driving Social Security's financial status are expected to become increasingly unfavorable starting at the end of this decade, when the leading edge of the baby boomers, the huge cohort born between 1946 and 1964, first becomes eligible for benefits. Over the past 25 years when demographic factors were more advantageous, the number of beneficiaries increased at about the same rate as the number of covered workers. That situation is expected to change sharply as the number of beneficiaries mounts rapidly while growth in the number of workers slows. The coming surge in beneficiaries is tied both to the retiring baby boomers and to the lengthening life span of retirees. The expected slowdown in labor force growth is the result of the exit of the baby boomers from the labor force, which will leave a working-age population increasingly drawn from the smaller cohorts born after the baby boom.

Social Security's actuaries project that the worker-to-beneficiary ratio will fall from its current level of 3.3 covered workers per retiree to about 2 workers per retiree in 2030, with most of the change occurring after 2010. After 2030 the ratio is expected to continue to decline, albeit at a slower pace, dipping to 1.85 workers per beneficiary by 2075. Although all projections are uncertain, demographic projec-

tions such as these are likely to be less so because the sizes of the retired and working populations are reasonably well known for several decades. One uncertainty is the course of life expectancy.⁸ Other uncertainties are changes in immigration and in work participation at older ages, both of which could influence the growth in the labor force. However, both immigration and work participation can be affected by policy, which is not easy to predict.

Long-run projections of the financial status of Social Security are directly related to the ratio of covered workers to beneficiaries. As noted, the Social Security surplus is expected to shrink rapidly after 2010, turning to a deficit in 2016 that will continue to grow in future decades. The existence of a trust fund of trillions of dollars recorded in the accounts will not pay the bills. At that point what will matter will be the ability of the government to make good on the promise implied by the fund. Under current policy, Social Security benefits alone will consume an increasing share of the nation's resources. The CBO estimates that benefits will increase from 4.2 percent of GDP this year to 6.5 percent in 2030.⁹ Moreover, government expenditures on Medicare and Medicaid, two other large programs that serve the elderly, are likely to rise even faster than Social Security benefits because medical benefits are open-ended. CBO estimates that, taken together, Social Security, Medicare, and Medicaid will increase from close to 8 percent of GDP this year to almost 15 percent in 2030 if current policies are unchanged.

Can a Near-Term Surplus Help Close the Post-2016 Deficits?

Although the future for Social Security finances looks bleak after 2016, the most recent CBO projections indicate a large and growing Social Security surplus over the next decade, cumulating to \$2.5 trillion from 2003 through 2012. Not surprisingly, a number of proposals suggest using that surplus to help pay the benefits of future retirees. Unfortunately, calling the tally of past Social Security surpluses a "trust fund" gives the impression that we have a direct mechanism—a "lock box," so to speak—for saving the current surplus to cover future shortfalls. But our current system affords no

such mechanism because Social Security is funded on a pay-as-you-go basis.

Social Security surpluses do provide the government with a source of current revenue. Typically, the sole use for those revenues has been to help cover deficits in the non-Social Security side of the budget—a practice, as discussed above, that has likely encouraged the growth of non-Social Security spending. However, the shrinking of the non-Social Security deficit in 1998 and the emergence of a unified budget surplus gave rise to the idea that the Social Security surplus could be used to help fund the benefits of future retirees in an indirect way. That indirect way is to apply any unified-budget surplus that materializes toward retiring the publicly held debt.

Debt reduction might ease Social Security's future funding gap in two ways. First, reducing the debt reduces the annual interest charges the government pays on that debt, and doing so would presumably free up budgetary resources to be used for other purposes. However, there is no guarantee that those budget savings will be committed to paying Social Security benefits.

The second way is even more indirect. It relies on the presumption that retiring the debt would reduce interest rates and increase national savings, thereby enlarging the volume of funds available for investment and ultimately boosting the size of the economy and the incomes of future workers and taxpayers. However, it is debatable whether this favorable chain of events would occur with the strength needed to produce a significant increase in future national income.¹⁰

There are also other, simpler, ways in which saving the surplus is not a reliable approach to solving the long-term problems of Social Security. First, for both economic and political reasons there may be no significant surplus to save. The budget projections made by CBO and the Office of Management and Budget at the start of 2001 showing large and growing surpluses came on the heels of several years of extraordinary growth that had converted total budget deficits into surpluses. Those projections have been scaled back in light of the slowdown in the economy in 2001 and the new defense and other demands placed on the budget after the attack on the World Trade Center of September 11, 2001. In addition, history suggests that if large surpluses return, they will not likely remain

unclaimed for long.¹¹ That probability is not necessarily a bad thing because other uses for the surplus—funding the transition costs of individual Social Security accounts, for instance, or a well designed tax reform—may be regarded as more beneficial than retiring the debt.

In the late 1990s, the prospect of a future of total budget surpluses inspired proposals to pre-fund future obligations by investing the surplus in private assets.¹² Proponents claim that investing the surplus in private assets is particularly attractive because if history is a guide, such investments would yield a high return. However, when a federal entity invests in private companies, numerous problems can easily arise. The size and composition of such government investments could destabilize markets. And at a time when the mere meeting of an economic group such as the World Trade Organization attracts legions of protestors, such public investment in private markets could be a source of ongoing political conflict.

Of course, as with any proposal that relies on using the surplus, federal investment in private assets depends on ensuring that the surplus is not diverted to other uses and that the earnings from the investment are dedicated to future Social Security liabilities. These types of investments are not the same as investments made by private individuals who own their own accounts. The only way to reliably pre-fund retirement benefits is through a system of individual accounts that are privately held and owned by the worker. Such an undertaking would require a more fundamental change in the system, as discussed below.

Can We Rely on Tax Increases Once Again?

In the past, as Social Security expanded, impending deficits were primarily resolved by raising the payroll tax rate and the ceiling on taxable covered earnings. From 1937 to 1949 the combined tax rate on workers and their employers was 2 percent. Today it is 12.4 percent in the OASDI programs and 15.3 percent when Hospital Insurance is added. The ceiling on taxable earnings was also increased, both absolutely and as a percent of the average wage. In 1951 it was \$3,600, which was close to 150 percent of the average wage. By 1999 it

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had risen to \$72,600, or 251 percent of the average wage. (In 2001 the maximum taxable earnings cap for OASDI was \$80,600; the cap for the Medicare Hospital Insurance program was repealed altogether in 1993.)

Can taxes be raised again to resolve the coming crisis? Based on the actuaries' estimates, increasingly large tax hikes will be required simply to cover annual OASDI benefit costs after 2016. By 2035 taxes would have to increase by 4.6 percentage points of payroll to close the expected shortfall—about a 35 percent increase over the current tax level. The required tax increases would remain at that level until about 2050, when they would begin to mount still higher. Those estimates do not include the projected shortfall in the HI program, which is expected to grow even more rapidly than that in OASDI, almost doubling the size of the required tax increase by midcentury. In short, the cost of the combined OASDI and Hospital Insurance programs is projected to increase from its current level of 13.3 percent of taxable payroll to almost 25 percent by midcentury if current law is unchanged. Currently, legislated taxes are expected to cover costs until 2016 (2015 in HI). But over the next 34 years taxes would have to rise by 50 percent (an 8.5 percentage point increase) to cover costs at midcentury. To rely on tax increases to fund the shortfall in Social Security and HI is to commit future workers to paying more than 18 percent of their wages to cover the benefits of retirees in another 18 years and 25 percent of wages to cover benefits at midcentury.

Fundamental Change

Social Security faces two different but related issues. One is the unsustainable financial situation of our current pay-as-you-go system, which will begin to run increasingly large deficits in about 15 years. That issue has been a major focus of this paper up to now. The other issue is the more fundamental one concerning the type of retirement system we want.

Over the past decade many analysts and at least two prominent government commissions have recommended major changes in Social Security.¹³ A common goal of the proposed reforms is to shift Social Security partly or mainly to a system of individual accounts. Such

a change would provide a mechanism for pre-funding benefits and avoiding the drag of the pay-as-you go system on the economy, and it would improve incentives to work and to save. Similar reforms have been adopted in various other countries.¹⁴ Moreover, within the United States, private retirement plans have undergone analogous changes as participation has shifted from defined benefit to defined contribution plans. The shift to defined contribution plans more closely ties pension contributions to benefits, ensuring that they are prefunded, and usually gives workers more flexibility and control over their assets.

The growing interest in fundamental reform of Social Security stems from a growing recognition of the drawbacks of the current program. As it is now structured, Social Security is funded like most government programs in that the taxes of current workers pay the benefits of current recipients. In other government programs, however, either benefits are appropriated annually, and can therefore be adjusted to meet changing conditions, or the program is an entitlement, targeted on a relatively small proportion of the population defined as needy. Social Security, by contrast, is broadly targeted on the elderly and disabled, not on need, and is committed to paying large and growing benefits to a large and growing portion of the total population. The attempt to fund such a program on a pay-as-you go basis when large swings in the birthrate and other factors cause major shifts in the ratio of beneficiaries to taxpayers is the source of the financing difficulty that we will soon face.

Is the existing program really what we want? Originally, the primary goal of Social Security, as stated in various government reports and presidential speeches, was to alleviate poverty among the elderly. In signing the Social Security Act on August 14, 1935, President Roosevelt said:

We can never insure one hundred percent of the population against one hundred percent of the hazards and vicissitudes of life, but we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age.

Social Security benefits, however, were

never targeted to the poor. The political wisdom, as expressed by Wilbur J. Cohen, one of the major developers of the program, held that “a program that is only for the poor—one that has nothing in it for the middle income and upper income—is in the long run a program the public won’t support.”¹⁵ Thus, from its early days, Social Security had a muddled mission. To support the program’s welfare goals, the formula for calculating benefits at retirement was set to provide benefits that replaced a larger share of past earnings for low-wage workers than for high-wage workers. But to maintain the allegiance of the majority, the program was given the trappings of an earned right, funded by worker “contributions”—which is actually a payroll tax that is somewhat regressive. And despite the provision for declining replacement rates as earnings rise, those with higher earnings still get higher benefits.

How effective is Social Security as an anti-poverty program? It is true that the poverty rate of people age 65 and older has declined sharply over the years—from 35 percent in 1959 to 9.7 percent in 1999. Social Security undoubtedly played a significant role in that decline, although the general rise in income in the economy also contributed. However, only a minor portion of Social Security’s huge expenditures actually serves to reduce poverty among the elderly. In 1999, in fact, only 20 percent of total Social Security expenditures would have been required to eliminate poverty altogether among those age 65 and over.¹⁶ Thus the bulk of benefits is paid to those who would not be poor in any event, while a small portion goes to those whose incomes without any benefits would have been below poverty by varying amounts. Moreover, Social Security provides no benefits or very low benefits to those who neither earned enough themselves to qualify for benefits nor were married to someone who was so qualified. And such individuals are among the poorest elderly. That is why the current poverty rate of the elderly is 10 percent and not 0. Viewed simply as a transfer program, Social Security does not get high marks for cost-effectiveness.

Many analysts have also examined the way in which Social Security redistributes income both across and within cohorts when lifetime tax payments and benefits are taken into account. A general finding is that within a

cohort, the effects of the progressive benefit structure that would tend to transfer income to those with lower earnings are partly or even fully offset by other factors such as the greater longevity of higher earners and the payment of spousal benefits.¹⁷

Many analysts also question the program’s effects on saving and labor-force participation. In a pay-as-you-go system young workers are taxed to pay the benefits of current retirees. The introduction of Social Security has likely led individuals to reduce their own private savings, expecting to substitute Social Security benefits for those savings. Because the flow of funds each year is a straight transfer from young workers to retired workers, the system is a deterrent to net savings and capital formation. It is plausible that substituting a system of individual accounts in which individuals prefund their own retirement would increase national saving and contribute to economic growth.¹⁸

It also is likely that by promising a relatively generous benefit at a politically determined age of retirement, Social Security has distorted the decision about when to retire and has contributed to the sharp decline in work participation over time among men age 62 and older.¹⁹ Work disincentives are greatest for low-wage workers who collect benefits that replace a high percentage of past earnings. Because Social Security provides only an annuity option, workers with shorter life expectancy, who are more likely to be low-wage workers, cannot receive a lump-sum withdrawal and therefore face a “use it or lose it” proposition. Moreover, because there is no asset accumulation, there is no possibility for bequests. The extent to which a move to individual accounts would improve incentives to spread work over older ages would depend on the particular design of the system. However, there is much more room for flexibility in such a system, which need not decree an arbitrarily set “age of retirement” and can allow for wealth accumulation with options for withdrawals and bequests.

Conclusion

Public discussion about the financial health of Social Security usually focuses on the long-run solvency of the system. Solvency is determined either by the year the actuaries estimate

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the trust fund will be exhausted (at present, 2038) or by the cumulated difference between Social Security receipts and benefit outlays over the next 70 years (at present, a shortfall of 25 percent of benefits).²⁰ However, focusing on trust fund balances misstates the problem. It can point out whether demographic trends are likely to be favorable or unfavorable. But by and large it does not raise the important issues relevant to system reform. It is time now to give serious thought to the question of the type of system we want to have.

Why do we need a government retirement program? As noted, from the start the main goal of Social Security was to prevent destitution among the elderly, who by dint of their age are assumed to be less able to fend for themselves. But that would call for a much smaller program focused only on the poor. The coverage of everyone else is usually said to be necessary because the young are myopic and would not perceive the need to accumulate assets for their old age in the absence of a government mandate. However, a mandate does not require a pay-as-you-go program. To the extent that compulsory saving is desired, it can be attained more directly with a system requiring individual accounts and the accumulation of privately held assets.

Most of the reform plans that have been proposed combine individual accounts with a pay-as-you-go component. That component varies in size from plan to plan but at least provides a safety net that can be designed to deal with redistributive goals. The most significant issue to be determined, however, is the overall size of the government program. We are now richer and better educated than our parents and grandparents; that trend is likely to continue with future generations. As a result, our ability to plan and direct our own lifetime savings should grow, particularly if changes are made in tax policy that eliminate saving disincentives. Thus in time we might plan for a reduced share of income going to a compulsory individual account system in the expectation that voluntary saving would grow. The generosity of the pay-as-you-go component is a particularly important consideration because the promise of a transfer that replaces a significant share of earnings is a very good reason not to save. Under the current system, benefits for new retirees have been growing much faster than

has inflation because they are indexed to wage growth.

Serious thought should also be given to reducing the growth of benefits in the pay-as-you-go component in future years, particularly for those with average or higher earnings. This reduction could be attained by increasing the retirement age or, preferably in my view, by transitioning to a price-indexed system, a method suggested in the second of the three proposals of the President's Commission on Social Security.

Whatever the final shape of reform, it is time for Congress to stop playing verbal games over what are essentially accounting gimmicks and get down to serious work.

Notes

1. The apt phrase "victim of demography" is Jacob Mincer's.
2. In the course of analyzing the president's budgetary proposals for 2003, CBO revised its baseline projections of January 2002 to take account of an improved outlook for the economy. The projections now show a unified surplus of \$6 billion in 2003, rising to \$653 billion in 2012. That figure is the outcome of a continuous off-budget surplus (rising to \$318 billion in 2012) and a declining on-budget deficit that converts to a surplus in 2010–2012. Because these are baseline projections, they do not include the effect of any additions to spending that likely will be enacted. Because they are projections they will undoubtedly change for other reasons as well. See the Testimony of Dan Crippen, director of CBO, before the Committee on the Budget, U.S. Senate, March 6, 2002.
3. See Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag, *Perspectives on the Interim Report of the President's Commission to Strengthen Social Security*, Center on Budget and Policy Priorities and the Century Foundation, July 23, 2001.
4. See Kent Smetters, "Has Mental Accounting Been Effective in 'Lock-Boxing' Social Security's Assets?: Theory and Evidence." University of Pennsylvania and NBER., August, 2001. Smetters' statistical analysis of the effect of increases in the Social Security surplus on non-Social Security spending covers the period 1979–2001 and includes controls for GDP growth, wages and salaries, and trend factors. His results indicate that the "leakage rate" could exceed 300 percent. That is, a one dollar increase in the Social Security surpluses is associated with a \$3.39 decrease in non-Social Security surpluses (i.e., outlays and/or tax expenditures and other tax reductions), other things remaining the same.
5. See John F. Cogan, *The Congressional Response to Social Security Surpluses, 1935–1994*, Hoover Institution Essays in Public Policy, 1998.

6. Spurred by an imminent financial shortfall, the 1983 Amendment to the Social Security Act made a number of unprecedented changes. On the revenue side, the payroll tax rate was raised in the near term by moving forward the tax rate increases that had been scheduled for later years and extending coverage to workers in nonprofit organizations and federal employees. Near-term benefits were effectively reduced for current retirees by postponing the scheduled cost-of-living adjustment for six months. Future benefits were reduced by raising the age at which full retirement benefits could be collected from 65 years to 67 years. The increase is phased in by two months a year starting with those attaining age 62 in 2000, and the full retirement age reaches 67 for those attaining age 62 in 2022. Social Security benefits were effectively further reduced by subjecting a varying portion of benefits to the federal income tax, depending on other income.

7. CBO, March 2002 projection.

8. Life expectancy at age 65 of the average 65-year-old has increased for men from 12.7 years in 1940 (the first year Social Security benefits were paid) to an estimated 16.3 years today, and for women from 14.7 years to 19.6 years (reported in Congressional Budget Office [CBO], *Social Security: A Primer*, September 2001). The projections to 2075 of the Social Security trustees assume that life expectancy at age 65 will continue to improve but at a slower rate. The trustees' assumptions have been questioned by demographers and others who believe that mortality is declining faster than the trustees expect. (See the discussion in Andrew G. Biggs, "Social Security, Is It 'A Crisis That Doesn't Exist?'" SSP no. 21, October 5, 2000.) If true, the financial imbalance would occur sooner than projected.

9. CBO, *Social Security: A Primer*.

10. Even assuming that a total budget surplus is realized over the next decade and that it is not used for any other purpose than paying down the debt, the extent to which national income would rise is uncertain. At issue is the response of private savers to the increase in government saving from running large surpluses. If private saving fully offset government saving, then there would be no net saving increase and no expected effect on investment and economic growth. (See the discussion in *Social Security: A Primer*.) However, this is a difficult matter to resolve. Rudolph Penner, Sundeep Solanki, Eric Toder, and Michael Weisner estimate that economic growth would be positively affected by saving the surplus, but the effect would be small. Based on a projection that a total budget surplus would be realized every year from 2000 to 2021 and that all of it would be saved, they estimate that the growth of consumption per capita would be 0.1 percent higher per year over the 1999–2023 period. By 2023 the level of per capita consumption would be 2 percent higher. See *Saving the Surplus to Save Social Security: What Does It Mean?* Urban Institute, *The Retirement Project*, Brief Series, no. 7, October 1999.

11. See Cogan, and Smetters (2001).

12. See Henry Aaron and Robert Reischauer, *Countdown to Reform* (New York: Century Foundation Press, 1998). For a discussion and critique see Martin Feldstein and Jeffrey B. Liebman, *Social Security*, NBER working paper 8451, September 2001, and CBO, *Social Security: A Primer*.

13. The 1994–1996 Advisory Council on Social Security, chaired by Edward M. Gramlich, produced three plans for reforming Social Security, two of which included a component of individual private accounts. The President's Commission on Social Security.

14. See James M. Poterba, S. P. Venti, and David Wise, "The Transition to Personal Accounts and Increasing Retirement Wealth: Macro and Micro Evidence," Working Paper 8610, National Bureau of Economic Research, Cambridge, Mass., November 2001.

15. Quoted in C. Eugene Steuerle and Jon M. Bakija *Social Security for the 21st Century, Right and Wrong Approaches*, (Washington: Urban Institute Press, 2000), p. 26.

16. This is the author's estimate based on calculations from the 2000 CPS microdata file. Poverty is based on a measure of income that excludes Social Security and all other transfer payments. The calculation takes the difference between nontransfer income and the poverty threshold for each person age 65 and over and sums these differences. For unmarried persons the poverty threshold for a single individual is used even if they were living with others. Separate calculations were made for married couples.

17. See, for example, Jeffrey Liebman, "Redistribution in the Current U.S. Social Security Program," NBER Working Paper 8625, 2001; J. L. Coronado, D. Fullerton, and T. Glass, "Distributional Aspects of Proposed Changes to the Social Security System," in James Poterba ed., *Tax Policy and the Economy* 13, NBER, 1999; Steuerle and Bakija, op cit; and the review and analysis in Feldstein and Liebman, 2001, op cit.

18. James Poterba suggests that there is considerable support in the economics literature for the view that a shift from the current underfunded system to a fully funded system would raise national saving. He also reports on a survey of public finance economists conducted by himself, Victor Fuchs, and Alan Krueger in 1997 that asked what these economists thought was the effect of Social Security on the personal saving rate. The median respondent indicated that the personal saving rate would have been 3 percentage points higher in the absence of Social Security. But, not surprisingly, there was substantial dispersion in the estimated magnitude of the effect. See Poterba's concise discussion of this complex subject in Eric M. Engen and William Gale's *Effects of Social Security Reform on Private and National Saving* (published in Steven A. Sass and Robert K. Triest, eds., *Social Security Reform, Links to Saving, Investment and Growth*, Conference Proceedings (Series no. 41, June 1997), Federal Reserve Bank of Boston.

19. See Jonathan Gruber and David Wise, eds., *Social Security and Retirement Around the World* (Chicago: University of Chicago Press, 1999). Also see the review and discussion of other research on the topic in Feldstein and Liebman, op cit.

20. Both measures seriously understate the problem because they assume that the trust fund can accumulate assets that in turn bear interest. As discussed above, the trust fund has no mechanism for investing current surpluses to cover future shortfalls. In addition, by confining the long term to the next 75 years much of the unfunded liability of the system is uncounted, since the Social Security deficit is expected to continue to grow after the 75th year.