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WEB EXCLUSIVES

Lessons From the Social Security Debate

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The debate over Social Security's future highlighted the crucial role it plays in insuring the basic income needs of middle-class families; it illustrated the different possible paths to improving Social Security solvency; and it raised the profile of a national debate over ways to increase retirement wealth in addition to Social Security. The outlook for its long-term finances shows no cost explosion, but rather a gradually widening gap between income and expenditures that can be addressed by a sensible combination of additional revenue and small benefit reductions.

In 2005, the country was immersed in an intense debate over Social Security's future. This discussion showcased two separate visions—publicly funded and guaranteed social insurance, versus a private investment vehicle—for Social Security's role. It also raised important questions about the ways to close the potential gap between Social Security's income and expenditures. Lastly, it strengthened a policy discussion on how to create sufficient private retirement wealth for most middle-class Americans.

After a year of intense debate, it is important to take stock of what was learned. The original intent of Social Security's role as social insurance became prominent and visible again after perhaps becoming obscured over time. After all, there are currently more beneficiaries with insurance benefits than with their own retirement benefits. The outlook for its long-term finances shows no cost explosion, but rather a gradually widening gap between income and expenditures that can be addressed by a sensible combination of additional revenue and small benefit reductions. However, this does not mean that the creation of private retirement wealth should not remain a policy priority.

Social Security's Benefits

Social Security offers crucial benefits to working families when the primary source of income disappears due to the retirement, death or disability of a worker. That is, Social Security is a social insurance program that offers retirement, survivorship and disability benefits to participating workers and their families.

Most of the Social Security reform debate focused solely on retirement benefits. However, its other insurance functions are, by some measures, larger. Particularly, only 49.7% of Social Security beneficiaries receive their own retirement check. The rest receive spousal, survivorship or disability benefits. Included among Social Security's insurance beneficiaries are, for instance, close to four million children (Table I). Importantly, the disability and survivorship insurance functions of Social Security play a disproportionately larger role for minorities and women than the retirement benefits do.

When considering Social Security's retirement function, it is important to keep in mind that Social Security was always meant only as a basic retirement income program. This is witnessed by the fact that its average replacement is approximately 40% of a worker's last earnings, considerably lower than the replacement rates of retirement benefits in other industrialized economies (Weller, 2004).

Yet, Social Security has played a disproportionate role in providing retirement income. The Social Security Administration (2005a) reports that people 65 and older received on average 60% of their income from Social Security in 2002. For 24% of people 65 and older, Social Security constituted at least 90% of their income. For people 65 and older in the middle of the income distribution, Social Security constituted on average 67% of their income. Thus, the proportion of retirement income from Social Security is typically much larger than the average replacement ratios would suggest.

Social Security's disproportionately large role as a source of retirement income serves as an indicator of inadequate private pension wealth. This begins with uneven pension coverage. While Social Security offers almost universal coverage to those nearing retirement, about one-quarter of households between the ages of 56 and 64 had no private pension (Table II).

In addition, private retirement wealth

Table I

Distribution of Social Security Beneficiaries

	Retirement			Survivorship	Disability
	Total	Own	Dual		
Number (millions)	29.5	23.4	6.2	6.8	7.6
Share of total	62.8%	**49.7%**	13.1%	14.5%	16.2%
Avg. monthly benefit (dollars)	$922.1	n.a.	n.a.	$ 792.0	$ 722.5
Children (thousands)	480.5	—	—	1,906.7	1,579.3
White children	350.1	—	—	1,234.4	1,034.3
Black children	96.8	—	—	418.1	327.1

Source: Chaurushiya and Weller (2005).
"n.a." indicates data are not available. "—" indicates that category is not applicable.

Table II

Coverage Ratios for Different Forms of Retirement Wealth

	Share of households with specific wealth					
	47 to 55		56 to 64		65 and older	
Year	**1983**	**2001**	**1983**	**2001**	**1983**	**2001**
Social Security	92.4%	98.2%	91.9%	97.5%	77.5%	92.9%
DC and DB pensions	69.5	73.5	70.9	74.4	66.9	62.4
Home ownership	76.2	76.6	77.7	82.5	74.3	79.0

Source: Weller and Wolff (2005).
All figures are in percent.

is rather unequally distributed. Women tend to have less retirement wealth than men, minorities less than whites and those with less education less than those with higher educational attainment (Figure 1).

As a result, Social Security wealth—already earned benefits—tends to constitute the largest store of wealth for the typical family. For households nearing retirement, those between the ages of 56 and 64, Social Security wealth typically constituted $203,600 in wealth in 2001, whereas private pension wealth typically amounted to less than one-fourth that amount with $48,000 (Table III).

Importantly, during the late 1990s, which were especially conducive to large changes in private pension wealth due to the combination of a strong labor market and an extraordinary stock market, Social Security wealth for middle-class families rose faster than private pension wealth. While private pension wealth in inflation-adjusted dollars rose by 22.5% from 1989 to 2001, Social Security wealth climbed by 59.2% during the same period (Table IV). That is, at the time, when private pension wealth should have improved the most, Social Security's role as a store of retirement wealth grew at almost triple the rate of private pension wealth. Social Security thus not only remained a crucial middle-class benefit; it also expanded its role.

Paying for Social Security's Future

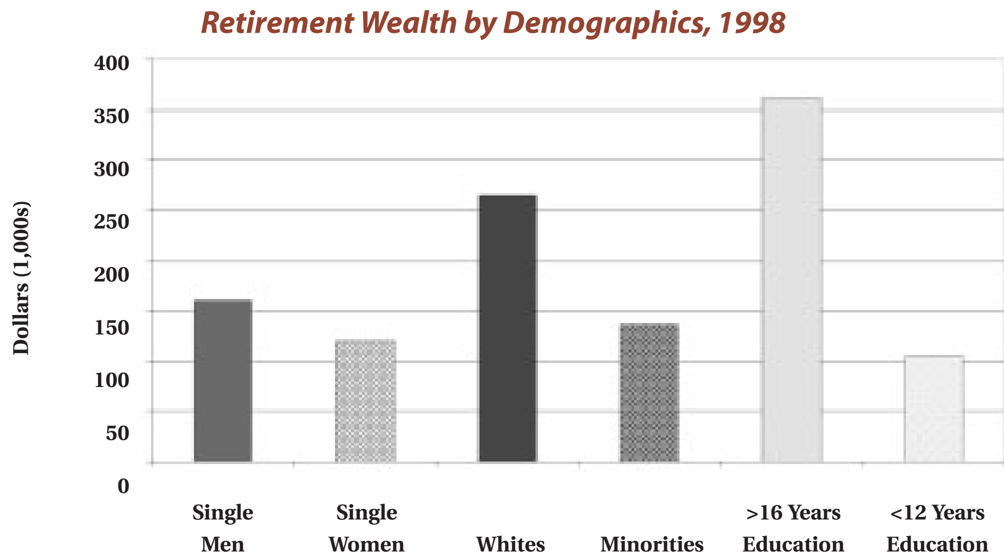
Will Social Security be able to perform its insurance functions to the same degree in the future as it did in the past? By all accounts, Social Security will ultimately spend more money than it will receive in the form of Social Security taxes and other income.

Two facts are important to keep in mind. First, Social Security's expenditures relative to the size of the economy—gross domestic product (GDP)—will rise, according to the Social Security trustees (2005b) from their current level of 4.3% to 6.3% in 2033. This increase reflects the expected retirement of the baby boom generation. However, after 2033, the costs of Social Security will remain virtually constant at about 6.3-6.4% of GDP for the foreseeable future. Hence, there is no cost explosion.

Second, the expected size of Social Security's shortfall is manageable. For the next 75 years, the Social Security trustees (2005b) project the shortfall will equal 0.6% of GDP. The nonpartisan Congressional Budget Office (2004) estimates that the shortfall will only be 0.4% of GDP. To put this in perspective, over the same 75-year horizon, the financial shortfall for the federal government created by the tax cuts of 2001, 2002 and 2003 were more than three times as large as the anticipated financial shortfall for Social Security (Orszag et al., 2003). It is thus a matter of policy choice whether Social Security can pay for its promised benefits.

The question is how to manage the expected shortfall, i.e., whether to increase revenue or reduce benefits. Although

Figure 1



Source: Wolff (2002).
All figures are in 1998 dollars.

Table III

Retirement Wealth in 2001

	Wealth in 2001, by age		
	47 to 55	56 to 64	65 and older
Median Social Security wealth	$160.7	$203.6	$127.0
Median DC and DB pension wealth	39.0	48.0	10.7
Median financial wealth	54.2	69.1	50.8
Median home equity	50.0	70.0	82.0

Source: Weller and Wolff (2005).
All figures are for 2001. All figures are in thousands of dollars.

President Bush failed to detail a complete plan on how he would address the expected shortfall, he proposed to reduce benefits to cover 59% of the anticipated shortfall (Furman, 2005). The benefit cuts would go into effect for anybody earning more than $20,000 in 2005 and be larger for higher income earners. For a medium wage earner retiring in 2045, the benefit cut would be 16% compared to promised benefits. In comparison, the benefit cut for a high wage earner, making $58,560 in 2005, would be 25% if she retired in 2045 (Furman, 2005).

The president's benefit cuts are so large because he by and large ruled out increasing revenue to Social Security. Yet, any serious reform effort should consider both sides of the equation. A number of options exist to increase revenue for Social Security. An often-overlooked source of additional revenue is the labor market. When employment growth is strong, wage gains are fairly equitably distributed, and when inequality is falling or at least not rising, Social Security's finances are improving. Despite the fact that workers increased their expected benefits under Social Security sharply from 1989 to 2001, as discussed earlier, the financial outlook for Social Security also improved (Figure 2). While improved wages and employment will mean higher future benefit payments, they also increase its revenue in the here and now. Over a period of six years, 1997 to 2003, the expected date of the exhaustion of Social Security's trust fund increased by 13 years—from 2029 to 2042. Thus, the projected date for Social Security facing a shortfall between income and expenditures moved very much in line with the labor market. When the share of taxable payroll—Social Security's tax base—increased, so did Social Security's long-term financial outlook, and vice versa (Figure 2).

An additional source of revenue is the restoration of the cap above which wages and salaries are no longer subject to Social Security taxation, $90,000 in 2005. In 2004, the cap meant that more than 15% of wages and salaries were not subject to Social Security taxation. This was up from 10% in 1983, the time of the last major Social Security reform, i.e., high-income earners received a gradual tax cut over a period of 21 years. Importantly, the share of taxpayers with incomes above the cap declined from 6.4% in 1983 to 5.4% in 2004. As a growing share of wages and salaries has become concentrated in the hands of a declining share of taxpayers, their relative tax burden has declined (Weller, 2005). If this decline in tax revenue to Social Security was reversed, such that a constant 90% of

Table IV

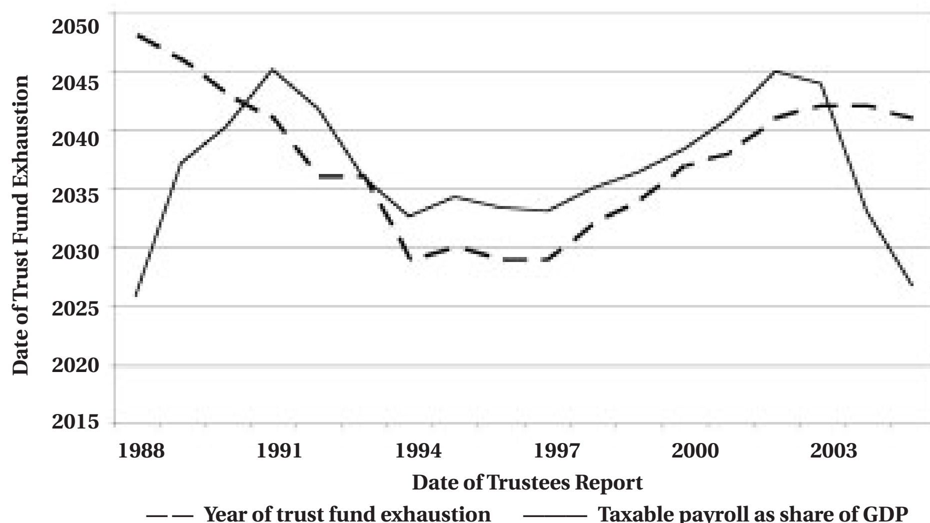
Changes in Retirement Wealth for Middle Three Quintiles, 1989 to 2001

Age	47 to 55		56 to 64		65 and older	
	Level (in 2001)	Change, 1989 to 2001	Level (in 2001)	Change, 1989 to 2001	Level (in 2001)	Change, 1989 to 2001
Social Security	$164.1	$42.0	$208.6	$59.2	$181.6	$48.2
Pensions	112.7	55.2	130.8	22.5	119.8	36.1

Source: Weller and Wolff (2005).
All figures are averages for middle three quintiles.

Figure 2

Taxable Payroll and Trust Fund Exhaustion Date



Source: SSA (2005b, 2005c).

wages and salaries were subject to Social Security taxation, 35.4% of Social Security's projected shortfall could be eliminated (Weller, 2005a) (Figure 3). If the cap were completely eliminated, starting in 2006, Social Security's expected shortfall would shrink by 93.8% (Weller, 2005a).

Another revenue measure to address Social Security's solvency could be general revenue transfers. For instance, the recent tax cuts on capital gains and dividends could be allowed to expire and the additional revenue could be dedicated to fund Social Security's shortfalls in the future. Such dedicated general revenue sources underlie the proposed comprehensive tax plan by the Center for American Progress (www.americanprogress.org/tax), which cuts the expected shortfall of Social Security, according to the estimates by the CBO, in half (CAP, 2004).

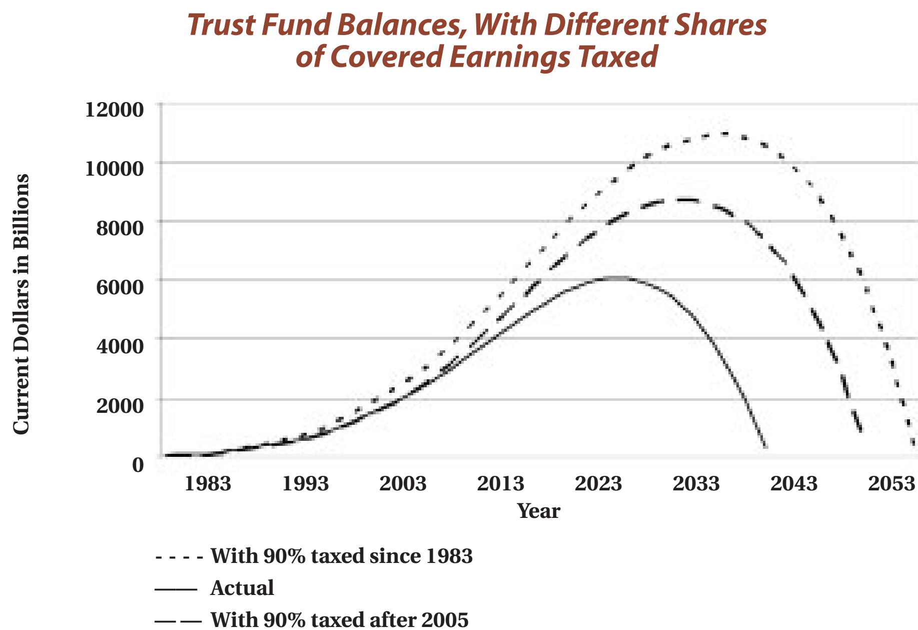
Social Security and Private Accounts

Proposals to divert funds away from Social Security into individual accounts not only do not address the gap between Social Security's expenditures and its income over the next 75 years, but they would actually widen that gap and further undermine the solvency of Social Security. Under such proposals, the government would incur additional debt because Social Security would no longer receive all of the funds it currently uses to pay for benefits. It would thus have to borrow money in financial markets to cover this additional shortfall. Although the size of the additional debt created by such proposals varies, all of them do increase the federal government's debt. In 2050, the government would incur $17.7 trillion (in 2005 dollars) in additional new debt under President Bush's proposal (Horney and Kogan, 2005).[1]

At the high end, under the proposal introduced by Senator Sununu (R-N.H.) and Representative Ryan (R-Wis.), which would allow for larger diversions into private accounts in addition to minimum benefit guarantees, the federal government's debt would increase by $85.8 trillion in 2050. In comparison, the proposal made by Senator DeMint (R-S.C.), which would only allow for the diversion of funds into private accounts as long as Social Security has a cash surplus, would increase the federal debt by $3.5 trillion in 2050 (Horney and Kogan, 2005).

Private account proponents, though, raise an important public policy issue,

Figure 3



Source: Weller (2005c).

even though their proposals do not address it. The issue at hand is the lack of adequate pension wealth for many households nearing retirement. As a rule of thumb, households should be able to replace at least 75% of their preretirement income in retirement. Weller and Wolff (2005) estimate that 44.1% of households nearing retirement—those between the ages of 56 and 64—were unable to replace at least 75% of their preretirement incomes in 2001.

Proposals to divert Social Security taxes into private accounts would not increase retirement wealth outside of Social Security and thus leave the issue of retirement income adequacy unaddressed. In particular, the contributions to private accounts would be offset by reductions in guaranteed Social Security benefits. These offsets would equal the original contribution to the private account plus inflation plus a predetermined interest rate, typically the interest rate on long-term Treasury bonds (Furman, 2005b). If expected rates of return are adjusted for risk, workers would on average not fare any worse or any better than if they had stayed with Social Security (Furman, 2005b). Considering that financial market risks can be substantial, there is a sizable chance that workers will do worse than expected, possibly requiring additional government assistance in retirement (Weller, 2005b).

Creating Private Wealth for America's Middle Class

This still leaves the relevant question as to how to improve retirement wealth outside of Social Security for America's middle class. To achieve this goal, public policy needs to address three goals: broader pension coverage, more equitable pension wealth creation and less risk exposure for retirement savings.

Pension coverage, especially among employers that offer defined contribution (DC) plans rather than defined benefit (DB) plans, can be increased by automatically enrolling all eligible employees. This tends to lead to substantially higher participation rates, especially among groups that have disproportionately low pension coverage, such as women, minorities or workers with low educational attainment (Gale et al., 2005).

In addition, a broader coverage by DB plans, where workers are automatically enrolled, could improve private wealth creation. There are some signs that the decline in DB plans has stalled in recent years and that in some areas of the economy, e.g., among white-collar workers, it may even be slowly increasing (BLS, 2005). This trend could be aided by making DB funding more predictable for employers since they would be less likely to abandon their existing plans (Weller, 2005c).

Further, the creation of pension wealth could be equalized by changing the tax incentives for contributions to DC plans. This would require a change from the current practice of making pretax contributions to giving everybody the same proportional refundable tax credit. Under current practice, higher income earners, who typically already save enough outside of Social Security, receive the largest proportional benefits. Low-income earners, especially those without any or with low federal income tax liabilities, see few if any tax benefits from this practice. As a consequence, the federal government's massive tax expenditures have little to no effect on wealth creation (Engen and Gale, 2000).

Finally, the risk exposure of working families with their retirement savings could be reduced in a number of ways. These would include prudent regulation of DC plans as well as more predictable contributions and higher funding levels for DB plans.

Conclusion

The debate over Social Security's future in 2005 proved useful. It highlighted the crucial role Social Security plays in insuring the basic income needs of middle-class families; it illustrated the different possible paths to improving Social Security solvency over the coming decades;

and it raised the profile of a national debate over ways to increase retirement wealth in addition to Social Security. As millions of American households are still entering retirement with too few savings and as Social Security will likely require additional resources over the longer run, neither the discussion over Social Security's future nor the debate over private wealth creation will subside anytime soon. **B&C**

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Endnote

1. All of the estimates in Horney and Kogan (2005) are based on calculations made by the Social Security actuaries.

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