Dr. Dave. I've read that the President's proposal to create personal savings accounts within the Social Security system will do nothing to reduce the system's projected revenue shortfall. Is that true? If so, what are the current proposals for dealing with the shortfall?

A. Something needs to be done to shore up the Social Security system. But creating private investment accounts does not address the system's financial problems.

Ironically, of the three zillion words written about Social Security since George W. Bush declared a radical reform his highest priority, 99.9 percent have discussed his proposal to create individual savings accounts. That proposal would divert a portion (perhaps 2 to 4 percentage points) of Social Security taxes into private savings accounts invested in stocks and corporate bonds.

Proponents argue that these accounts, in the very long term, will establish a sustainable financing basis for the Social Security system because such private investments will earn a significantly higher return than earned by Social Security funds currently invested in federal treasury bonds. (For those interested in examining both sides of this argument in some depth, go to AmericanVoice2004.)

Even the President's strongest supporters, however, do not claim that private accounts will address the short-term (40 years) trust fund shortfall.[1] Since the catalyst for the national debate about Social Security reform is the need to close this shortfall, we might better focus our attention on strategies that actually address that problem.

To do so, we first need to know the extent of the shortfall. Happily, by law, the Social Security Trustees must annually report on the program's ability to pay all projected benefits for the next 75 years.[2] When you hear a politician say that on a certain date the trust fund becomes "insolvent" it doesn't mean it goes out of business. It means it will no longer be able to pay 100 percent of its projected benefits. Currently, the Trustees project that after 2042 the trust fund will be able to pay only about 75 percent of its promised benefits.

Unhappily for those of us who would like precise estimates, forecasting 75 years out is a precarious and challenging task. The estimates depend on the assumptions. And the assumptions, even within the Social Security Administration itself, often change every year. Forecasters must estimate the rate of inflation, the growth in productivity and the overall economy, at what age people will retire, population growth, and a number of other factors far into the future.[3]

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[1] Indeed most observers believe it is more likely to exacerbate the problem because of the massive borrowing that will have to be undertaken to finance the transition.

[2] Beginning in 2003, the Social Security Trustees also included an estimate of the financial shortfalls in perpetuity.

[3] The 2003 Trustees report, for example, pushes the insolvency date back by assuming that older Americans stay in the work force longer than it had initially projected, and that there is more immigration (and therefore more payroll tax revenue).

Projections often are given as the amount the existing payroll tax would have to be raised to offset the deficit. In 2005, the total Social Security payroll tax is 12.4 percent, half paid by the employee and half by the employer.

These estimates have become much more positive in recent years. In 1998, for example, the Social Security Trustees forecast over the next 75 years, the program would be out of balance by 2.19 percent of taxable payroll. In the spring of 1999 that estimate was reduced to 2.07 percent. In the Trustees' most recent report, issued in June 2004, the estimate was further reduced to 1.89 percent.

The Social Security Trustees provide the official estimate used by Congress. However, equally reliable estimates exist. For example, in mid 2004 the Congressional Budget Office estimated the shortfall at 1 percent of taxable payroll. If we were to rely on the CBO's projection, we would need strategies only about 50 percent as onerous as those required if we rely on the Trustees report.[4]

One more point to consider. Before 1983, Social Security was a pay-as-you-go system. But the bulge in the population caused by the baby boomers led to a welcome bipartisan consensus that a trust fund was needed. Future claims would draw against that surplus.[5]

To establish long-term solvency, Congress significantly overhauled the Social Security system in 1983. Among the changes were: an increase in the payroll tax rate of about 1 percentage point; a requirement that federal employees and all employees of tax exempt, non-profit organizations become part of Social Security; a large lump sum transfer from the general treasury to cover short-term liabilities; the imposition of a tax on Social Security benefits for the first time; and raising the age of eligibility for benefits.[6]

Many of the proposed "fixes" currently on the table are similar to those instituted in 1983, although on the whole, they are less drastic.

What are the options?

1. Raise the Social Security tax salary cap.

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[4] For a discussion of the differences in economic assumptions and methodological techniques, see The Outlook for Social Security. Congressional Budget Office. June 2004

[5] The creation of the trust fund surplus also created a political dynamic that continues to haunt us. Remember Al Gore's famous and widely lampooned declaration that he would put Social Security's surplus into a "lock box"? He was saying that the federal budget surplus was largely the result of surplus Social Security tax revenues. (Only in the final year of the Clinton administration was there general fund surplus without the use of Social Security revenues.) Gore promised to guard against politicians raiding the trust fund to pay for current spending or tax cuts. A little guarding would have been quite salutary. As it stands, borrowing to finance current budget deficits severely compound the problem of financing Social Security (and Medicare and other programs).

[6] Summary of Social Security Amendments of 1983.

Today wage earners pay a Social Security tax only on the first $90,000 of wage and salary income.[7] Most current reform proposals raise the salary cap, although they vary dramatically as to how quickly and how far they do so.

Proponents argue that over the past two decades earnings have risen far more rapidly among workers with the highest earnings.[8] When the cap was first established in 1983, only 10 percent of wage and salary income escaped the Social Security tax. Today it is closer to 20 percent. Raising the cap from $90,000 to $140,000 would bring the percentage of income not being taxed closer to 1983 levels.[9]

Raising the salary cap to $140,000 would reduce by 30-40 percent the shortfall projected by the Social Security Administration and about two thirds of the shortfall projected by the CBO.

2. Require state and local employees to participate in Social Security.

This is similar to the 1983 reform that required federal employees and employees of tax-exempt, non-profit organizations to participate in Social Security. It would effectively expand the Social Security tax base to cover the 25 percent of government workers, some 3.7 million, who are now exempt.

This strategy would satisfy about 10 percent of the shortfall.

3. Link Social Security benefits to prices, not wages.

This is a component of virtually all conservative proposals, in all likelihood including that of the Bush Administration.[10]

At present Social Security benefits are tied to changes in wages. Real wage growth, on average, is positive. For example, the 2004 report of the Social Security Trustees projects a long run increase in prices of 3 percent a year, and a long run growth in taxable wages of 4.1 percent per year. That results in a growth in real wages (and real Social Security benefits) of 1.1 percent per year.

Thus someone retiring in 2005, with average lifetime earnings will receive an initial Social Security benefit of a little less than $15,000 per year. Someone retiring in 2030 with average earnings will receive an annual benefit, in inflation-adjusted 2004 dollars, of more than $19,000. Someone retiring in 2055 will receive $25,000.

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[7] The cap has been rising. It was $72,600 in 1999 and rose to $87,000 in 2003 and is now $90,000.
[8] Moreover, the life expectancy of people with higher earnings has also increased faster than the life expectancy of those with lower earnings. Thus less of the overall wage and salary income is subject to the Social Security tax and more benefits are paid out to high wage earners.
[9] The separate medicare tax limit has already been raised to $125,000.
[10] The Bush administration has not yet put forth a proposal.

Conservatives propose to link Social Security benefits to increases in prices, not wages. They call this "Real Price Indexing." This could lower retirement benefits, in real terms, by as much as 40 percent.

The CBO, for example, examined the Real Price Indexing plan proposed by the Bush-appointed Commission to Strengthen Social Security. It concluded that under the current benefit formula, the median Social Security benefit for median-wage workers born in the 1990s who claim benefits at age 65 would be $1942 per month, or 39.5 percent of previous wages. Under the Real Price index proposal, they would receive $1208 per month (including the payouts they would receive from their individual accounts). This would reduce the replacement rate to 25 percent of their previous wages.[11]

4. Reduce benefits.

This is a component of all plans, and can reduce the projected shortfall by 20-30 percent or more. But in this element, the devil is in the details. Some proposals have an almost across-the-board reduction in benefits coupled with an increase in the retirement age. Others devise a much more complex to deal with inequities.

MIT economist Peter A. Diamond and Brookings Institution economist Peter R. Orszag, for example, reduce benefits but are much more generous to poor workers, widows and disabled and children who survive the death of their parents. They propose to cut benefits by 0.6 percent for a worker currently 45 years old, but 8.6 percent for a future retiree who is now 25. Affluent retirees are hit the hardest, while benefits for minimum wage workers and widows would increase.[12]

5. Raising the Social Security payroll tax rate. Many proposals include some increase in the Social Security tax rate, although the Bush Administration and conservative Republicans strongly oppose a tax increase.

6. Dedicate new sources of funding to Social Security.

Several proposals include new, dedicated sources of funding for Social Security. These proposals stem from the same philosophical perspective that informs the proposal to raise the cap on wage and salary income that is taxable. In that case, the argument is that the wealthy have increased their earnings much faster than those with lower incomes and this has reduced the percentage of wage income revenue available for Social Security taxation. Diamond and Orszag, for example, propose a 3 percent tax on all wage and salary income above the cap.

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[11] Long Term Analysis of Plan 2 of the President's Commission to Strengthen Social Secuirty. Updated September 2004. Congressional Budget Office.

[12] See Peter A. Diamond and Peter R. Orszag, Saving Social Security: A Balanced Approach. Brookings Institution Press. 2004. For a summary see, Reforming Social Security: A Balanced Plan. Policy Brief #126, Brookings Institution. December 2003.

Others argue that the Bush tax cuts have singularly benefited the very wealthy while significantly increasing the overall federal debt. Indeed, some argue that the tax cuts "raided" the Social Security trust fund and have compounded the difficulty of developing solutions to its modest financial shortfall.[13]

Thus a number of proposals, including one by Robert Ball, a former Social Security commissioner, argue that the estate tax should not be phased out in 2009 but rather directed to Social Security. That could reduce the shortfall by 20-40 percent.[14]

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[13] When Social Security taxes are no longer generating a surplus, the federal government will have to borrow or cut spending to pay benefits. Large deficits under the Bush administration have increased the federal debt burden, creating the possibility that future borrowing would raise U.S. debt burden to an unsustainable level of GDP. This was also the basis for discussions in 2000 about whether to use federal budget surpluses to pay down the debt. Had the debt been paid down, or at least not increased, future borrowing would have been less problematic.

[14] The Center for Budget and Policy Priorities (CBPP) points out that before the 2001 tax cuts took effect, estates worth less than $675,000 for an individual ($1.35 million for a couple) were exempt from estate tax. That exempted the estates of about 98 percent of Americans. By 2009, estates worth up to $3.5 million for an individual ($7 million for a couple) will pay no estate tax. This will exempt 99.7 percent of Americans. Repealing, as the Bush Administration has proposed in 2009, would therefore benefit only 0.3 percent of the American households(3 out of every 1,000). More than half of the benefits will go to 500 estates each year, worth on average more than $15 million per estate Robert Greenstein, Peter Orszag, Richard Kogan, The Implications of the Social Security Projections Issued by the Congressional Budget Office. Center on Budget and Policy Priorities. June 14, 2004.