Saving Social Security the Right Way.

(Transcript of a talk given by Thomas R. Michl, Mellon Visiting Professor of Economics at Skidmore College, April 20, 2005.)

Providing retirement security is a major responsibility for the U.S. government. Roughly one out of every five dollars spent by the Federal government goes to Social Security benefits. The problems of social security may not be the most serious facing the U.S. government, but if we can improve its finances, that will make it easier to meet some of the other fiscal challenges of the 21st century, such as Medicare, which everyone agrees is far more pressing, complex, and intractable.

I want to argue tonight that we can fix social security so that it provides a better deal for young workers, and so that it remains solvent for the foreseeable future. To do that will require a serious commitment of general revenues toward funding social security so that we no longer have to rely on the pay-as-you-go financial structure that currently supports the system. While I will take issue with the Bush Administration's proposals for individual accounts, they deserve some credit for beginning a worthwhile national conversation about how social security is funded. However, most of their crisis rhetoric about the financial health of the system has been exaggerated and often just plain wrong. A secondary argument I want to explore tonight is that demography is not destiny: the social security system is not in danger from a tsunami of aging baby boomers that will bankrupt the generations that follow them.

Social Security was designed to serve as a backstop, providing a solid foundation for retirement security rather than as the sole source of retirement income. In the popular metaphor of a three-legged stool, it is only one leg, while occupational pensions and personal saving provide the other two legs of a comprehensive retirement plan.

Yet a significant fraction of workers relies heavily on the Social Security benefits to provide a secure retirement with dignity. These benefits make up more than half of the income for over two-thirds of retired workers. For a third of retirees, they make up over 90 per cent of income. And one fifth of retirees have no other source of income besides Social Security. It is clear that Social Security forms a significant part of what political economists sometimes call the 'social wage'—the part of labor compensation orchestrated by the state. No wonder that this program has been dubbed the 'third rail' of American politics.

To support this system, we pay the FICA tax, usually called the payroll tax, that is dedicated to the social security program. Currently, workers pay 6.2 per cent of their wages, up to a cap currently set at $90,000 and indexed to average wages. Employers pitch in another 6.2 per cent, but most economists believe that regardless of who writes the check, workers ultimately pay this part of the payroll tax, too. As a result of this 12.4 per cent tax on wages, roughly 70 percent of households now pay more in payroll taxes than they do in income taxes. The Bush Administration, evidently betting that young workers are not going to be satisfied with the return they are getting on their substantial payroll contributions, has made the creation of private accounts the major domestic policy initiative of 2005.

As was revealed in a leaked memo from Peter Wehner, a White House operative, the Bush Administration initially planned to retail privatization as a way to solve the long-term solvency problems of the system. But that plan had to be scuttled because, as Democratic critics quickly pointed out, privatization in fact does nothing to address the solvency problem.
When the original plan failed, the Administration switched to Plan B, which seems to be based on neutralizing the voice of older Americans by promising to leave their benefits alone while winning the support of younger workers by offering them a better deal through private, personal, or individual accounts. Plan B now seems to have failed as well. Polls tell us that older Americans,

while believing the Administration's promises about their own benefits, are strongly opposed to privatization because they want to leave their children and grandchildren a social security system that works at least as well as it did for their generation. Meanwhile, younger workers, while relatively more receptive to individual accounts, are largely unenthusiastic once the details of the benefit cuts and the risks of stock market losses are explained to them.

The Democrats and progressive supporters of the social security system have played a major role in stopping Bush's privatization campaign in its tracks. But they have done little else to offer solutions to the problems, real or alleged, of the system. In a widely-discussed memo, political analysts James Carville and Stanley Greenberg, have argued that this is a mistake. The Democrats may be winning the battles over Social Security, but with their David Spade, 'just say no' strategy, they are losing the war. Carville and Greenberg base their argument on polling data, which tells them (quote) : "Voters are looking for reform, change, and new ideas, but Democrats seem stuck in concrete." My students have been telling me something like this for over a decade, and in fact, that is one of the main reasons I have taken this issue up as the focus of my personal research agenda.

One thing I hear from my students is that Social Security needs to be modernized. Social Security was designed during the Great Depression. The pressure to operate on a "pay as you go" (or PAYGO) basis was overwhelming. PAYGO means that each generation pays taxes to support their parents' retirement benefits, rather than putting the money into a fund to support their own benefits. During the Depression, economists used the newly-developed Keynesian theory to argue that getting unemployment down was the priority. Paying out benefits before the trust fund had grown was the right call from that perspective. It got older workers out of the labor force, spending their benefits to create demand. At the same time, conservative politicians were also opposed to building up the trust fund, on the grounds that it would lead to government ownership and socialism. So we got a PAYGO

system out of this peculiar alliance, and that has worked pretty well. Is it time to reform this system? So many Americans now own mutual funds and have gained familiarity with the principles of investment that perhaps it would make sense to reform the system in the direction of individual accounts?

I think it makes sense to move in the direction of a greater level of funding, but that individual accounts would not really be the right way to modernize the system. As I will detail more below, we can offer young workers a better deal than they are currently getting from Social Security, and do it in a way that also addresses the disturbing growth in the inequality of income, wealth, and health status in the United States over the last three decades. The growing inequality in the U.S. is a topic worthy of its own talk, but I'll just mention some factoids to dramatize the problem. First, according to Edward Wolff, by the 1990s, one person owned as much wealth as 40 per cent of the nation's households combined. (I'll let you guess his identity.) Second, according to a study by Thomas Picketty and Emmanuel Saez, the share of income going to the top 1 percent rose during the 1980s and 1990s and reached a level in 2000 that was the highest since right before the Great Depression, in 1929. In other words, income is almost as concentrated now as it has been at any point in the last century. A central premise of my talk is that this trend is not healthy for a democracy and reversing it ought to be a priority for public policy.

The key is to strengthen the existing system by using general revenues to fortify the Social Security trust fund. The technical term for accumulating assets in the trust fund in anticipation of future benefits is 'advance funding' or 'prefunding'. Prefunding has traditionally been associated with conservative policy analysts, such as the Harvard economist Martin Feldstein. But there is nothing to prevent us from prefunding the system using progressive taxes that mainly fall on the wealthiest households, in effect asking them to take some responsibility for the security of the broad masses of working families whose labor is to some

extent responsible for the great wealth stored up in the fortunes of the top 1 or 2 wealth percentiles.

In addition to addressing any insolvency issues (which I think are exaggerated), prefunding will improve the rate of return that we receive on our payroll taxes, and that will strengthen the system politically by taking away the main complaint that conservative opponents have traditionally leveled at the system—that you would be better off investing on your own.

Individual accounts represent an alternative, I would argue inferior, method of prefunding. There are two signal advantages to prefunding the existing system. First, individual accounts will necessarily require some fairly hefty administrative expenses that will eat into the returns. The trust fund, on the other hand, minimizes those expenses through financial economies of scale. Second, individual accounts are based on the "defined contribution" principle that makes workers bear the risks of investing in stock and bond markets. The trust fund effectively lets us spread that risk over a large population, and over different cohorts, preserving the "defined benefit" nature of the social security system. In a world that is already asking workers to accept more risk in terms of jobs, wages, and privately provided pensions like 401(k)'s, it is imperative that we preserve this feature of social security. This is the right way to modernize social security.

Is this a crisis?

Before we get into the specifics, we need to put to rest some of the myths and half-truths that are circulating about the financial status of the system. The Bush Administration seems not to have abandoned its original game plan completely, as Bush continues to repeat the mantra that the system is broken, and personal accounts are at least part of the solution.

The problem with this line is that everyone agrees to use the projections published by the Trustees of the Social Security Administration, who by the way are (with one exception) appointees of the President. And those projections show that under the 'most likely' scenario, the Social Security trust fund will keep the system paying full scheduled benefits until 2041, for over 35 years. After that, the taxes coming in will only be able to finance about 74 per cent of scheduled benefits. But before we panic, let me point out that social security benefits are indexed to average wages, which increase in real, inflation-adjusted terms, as productivity increases. So even after knocking 26 per cent off the average benefit in 2041, it will still be higher in real terms than the benefits received by recent retirees. Although cutting benefits by one-quarter is certainly not an acceptable state of affairs, this is hardly the picture of a catastrophe. You would not call a company bankrupt whose dividends first rise by 50 per cent over the next several decades and then drop by one-quarter, and yet the Bush Administration and its supporters repeatedly use loaded terminology like that to create panic among the citizenry.

But to make the crisis seem more immanent, a popular rhetorical device of the Administration is to claim that the 'day of reckoning' is not 2041, but 2017 when the system begins to run 'cash deficits' (i.e., benefits will exceed taxes), after running cash surpluses since 1984.

A little history is in order. Traditionally, Social Security operated on a strictly pay-as-you-go or unfunded basis. When it truly faced bankruptcy in 1983 (it was borrowing from the Medicare trust fund to pay benefits), President Reagan acted. Sensibly, he appointed the bipartisan Greenspan Commission which recommended some modest tax increases and benefit reductions that would put the system in actuarial balance for the 75-year planning horizon. The main benefit reduction, incidentally, is just now taking effect as the 'normal retirement age' increases from 65 (set in the original 1935 act) to 67. A surprising number of people seem unaware that the NRA is now 66, and it will turn 67 for those cohorts born after

1960. The basic plan is for the baby boom generation to partially prefund its own retirement, by running a cash surplus of taxes over benefits in order to build up the trust fund, which will then be run down to help pay the benefits when the boomers hit retirement. The leading edge of boomer retirement arrives in 2008, when the oldest boomers reach the minimum retirement age, which is still set at 62.

With this background, you can see that it is more than a little disingenuous for the Bush administration to claim that dipping into the trust fund constitutes a 'crisis' for the system, since this was the plan all along.

To distract us from this obvious point, privatizers often say the trust fund contains no real assets; it is only invested in paper IOU's of the government; or that it is just one part of the government owing another. They say that when 2017 rolls around and interest and principle on the trust fund begin to finance social security benefits, the Treasury will have to raise taxes, cut spending, or borrow, just as it would if those debt certificates did not exist.

Incidentally, when President Bush announced to the world that he had seen the trust fund in a filing cabinet in West Virginia, and that it is 'just IOU's' and contains 'no real assets,' he may have violated the US constitution. Article 14, Section 4 states that: "The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned."

But more to the point, this argument makes a dog's breakfast of careful accounting. We should not restrict blame to the privatizers; confusion about the trust fund is rife in public discussions. A recent New York Times article on the trust fund, entitled "At heart of Social Security debate: a misunderstanding," proves its central point by itself misunderstanding the trust fund. It allegedly paraphrases Douglas Holz-Eakin, the director of the Congressional

Budget Office as follows, "The trust fund is more than an empty promise, he said, and less than a solemn obligation backed by the full faith and credit of the United States.". In fact, what Holz-Eakin actually told the reporter was that social security benefits, not the treasury bonds in the trust fund, are not legally binding contractual agreements, which is true as a point of law. I know because I asked him when he spoke recently at Hamilton College.

From the standpoint of the social security system, the special non-marketable Treasury certificates held by the trust fund are most certainly real assets. That they are paper is immaterial; almost all assets in a financially complex capitalist economy are paper, or even electronic bits and bytes stored in a computer somewhere. The U.S. bonds in the trust fund are claims on the general revenues of the US government, backed up the by its full faith and credit, regardless of what that NYTimes reporter says. These are about the safest financial assets available; the U.S. is not likely to default on its debt obligations.

If we take the perspective of the government, it is true that the trust funds do not represent any real assets, just one branch owing another. In that sense, the trust funds represent a bookkeeping device for tracking revenues and costs. But there is a substantive issue here that ought not be overlooked.

To suggest that after 2017 we should cut benefits to deal with the 'crisis' is to suggest that reneging on the deal struck by the Greenspan Commission is thinkable. Note carefully what that would imply. Workers in the boomer generation have overpaid, through a regressive payroll tax, and that fact is recorded by the bonds in the trust fund. Those bonds will be serviced (i.e., interest and principle paid) out of general revenues, which mostly means the income tax. The income tax is a highly progressive tax. The top 5 percent of households by income pay about half the income taxes, even after Bush's tax breaks for the rich. So when the boomers retire, the plan is to be able to legitimately tap some of that income tax revenue from the Bill Gates's of the world to pay

the boomers' social security benefits. To renege on this deal would have obvious distributive repercussions.

Note that we do not normally speak of the 'solvency' of other parts of the government, like the Pentagon. Social Security is unique in having a dedicated funding source. It is "off budget" by law. That is why it is appropriate, and good accounting practice, to speak of the solvency of the system, and that is also why it makes no sense to pretend the system is insolvent just because it will have to redeem its Treasury bonds.

When the privatizers are pitching to professional economists, incidentally, they make a different argument, which is that the trust funds have not added to national saving. From the standard, ceteris paribus, methodology preferred by economists, the social security surplus post-1983 have certainly added to national saving. Government saving is part of national saving. But the privatizers argue that ceteris has not been paribus. The social security surpluses were used, they say, as an excuse to run deficits in the rest of the budget (called 'on-budget deficits'), with no effect at all on national saving. This may, to some extent, be true. Most of the budget battles of the 1980s and 1990s were over the unified budget, which includes the so-called 'off budget surplus' that is mainly social security. A policy goal of balancing the unified budget, as a matter of arithmetic, requires that any off-budget surpluses be offset by deficits in the rest of the budget.

The privatizers want to stretch this plausible argument into a case for individual accounts. They say that only by putting the money in personal accounts will we be able to keep the politicians hands off that money. But this is a non sequitor. Congress could adopt a statutory policy of targeting the on-budget balance so that any social security surpluses are dedicated to increasing national saving. We know from the experience of the 1990s that Congress can impose effective restrictions on the budget process, and live with them.

So the 2041 date is the generally-agreed point at which the financial imbalances in social security become acute. We all know what is basically causing the problem. We are aging as a nation, as the result of lower fertility and longer life expectancy. Note that the common perception, that the stresses are caused by accommodating the baby boom generation, is not quite right. By 2041, the youngest boomers will be 77 and most boomers will be as deceased as the Monty Python parrot. The Greenspan plan will mainly have worked, in the sense of financing the boomers' retirement. But the imbalance will continue after the boomers because we are living longer, and because population growth is projected to slow down. These trends will raise the ratio of workers to retirees, from around 3 where it stands now, to around 2. In a pay-as-you-go system, where each generation of workers pays for its parents' retirement, this produces obvious stresses.

But how much stress depends critically on growth in the payroll tax base, and that in turn depends on growth in real wages and employment. No one can possibly know what will happen to these crucial economic variables in the next 75 years. Imagine trying to predict economic growth over a 75-year horizon beginning in 1930. Would anyone have been able to foresee WWII, the baby boom, the post-war 'golden age' of capital accumulation, computerization?

This reminds me of a story told by economist Ken Arrow. Arrow was in the army during WWII, working on mathematical models of weather. His group decided that the weather could not be predicted, and sent a memo to their commander asking for reassignment. In the reply, their commander said, "the commanding general is well aware that the forecasts are no good. However, he needs them for planning purposes." In many ways, the Trustees are in the same weird position. Appropriate to their fiduciary responsibility, they make fairly conservative assumptions about growth. And they make a range of three projections from optimistic to pessimistic. Most observers concentrate on their intermediate projection, since it represents what they think is 'most

likely' (though again, that needs to be discounted by their fiduciary conservativism).

[italicized text was not included in the talk]

After 2041, the Trustees project that paying scheduled benefits would require funding the obligations that taxes do not cover. These are called unfunded obligations. They give rise to some of the trully mind-boggling numbers that privatizers sometimes use to dramatize the plight of the system. The Trustees Report, starting in 2003, began publishing the present value of the unfunded obligations over a 75-year and also over an infinite horizon. This was apparently done at the urging over the conservative critics of social security, and if that is true, they have gotten their wish. Over an infinite horizon, the present value of the unfunded obligations are now around $11 trillion, and the privatizers have not hesitated to use that figure to foster panic. Present value calculations take into account the time value of money—the fact that money can be invested and earn interest. As a result, a dollar far off in the future are worth less today (since you could invest a small amount today and it will grow to be worth a dollar through the magic of compound interest). Its possible to add up the present value of the obligations all the way to infinity because this discounting operation eventually makes future dollars vanishingly small.

There are several problems with this calculation, not the least of which is that projections over even the 75-year horizon, not to mention infinity, are pretty sketchy. That is one reason that the American Academy of Actuaries formally recommended that the Trustees refrain from reporting this number, arguing that it is likely to sow confusion among unsophisticated users. They did, however, praise the Trustees for also reporting a much more meaningful statistic, which is the ratio of the unfunded obligation to GDP over the same infinite horizon. This puts the obligation into context, relative to the resources for closing it. As a share of GDP, these $11 trillion in obligations are only around 1 per cent,

and as a share of taxable payroll, they are only around 3.5 per cent. In other words, an increase in the payroll tax of 3.5 percentage points (from 12.4 to 15.9 per cent) would eliminate the imbalance from now until forever. The Bush Administration has been characteristically silent about this stubborn fact.

Another scary number the Bush Administration has exploited is the $600 billion annual increase in the unfunded obligation. They say this is the cost of waiting to fix the system. But it turns out that this number just represents an accounting fact: the net worth of any entity increases every year by an amount equal to the interest rate used for discounting its future surpluses or deficits. The actuaries use a 6 per cent discount rate, and 6 per cent of $11 trillion is (roughly) $600 billion. The same effect works on the present value of future GDP, which increases every year by the growth rate of GDP. The ratio, that is the more meaningful measure, therefore rises by a small amount, say from 1.2 to 1.22 per cent of GDP. The true cost of waiting turns out to be substantially less than the $600 billion.

Now let us turn to the Trustees projections themselves.
Take a look at this Figure showing their projections for trust fund balances under the three scenarios: low cost (optimistic), intermediate, and high cost (pessimistic).

[Figures appear at the end of this transcript.]

Note that under the intermediate scenario, the trust fund continues to grow after 2017, when the system has cash deficits. That is because the trust fund earns considerable interest income, out of which it can still accumulate funds for another decade, until around 2027. After that, the bonds are redeemed to pay benefits until the fund runs out in 2041.

I should point out here that the nonpartisan Congressional Budget Office, using a similar methodology, puts that date of trust fund

depletion as 2052, mainly because of different assumptions about the rate of interest on the bonds in the trust fund.

The pessimistic scenario suggests that trouble arrives in 2030. But the optimistic scenario suggests that trouble never arrives! The system will effectively achieve the status of 'partially funded' indefinitely. Under the optimistic scenario, the interest on the trust fund alone will pay over _ of the benefits by 2040.

How likely is it that the optimistic scenario will materialize? We need to look at the assumptions underlying these scenarios in some detail. Remember the fiduciary conservatism of the Trustees? It turns out that even their low cost scenario involves some pessimism about future growth prospects.

Take a look at this chart, showing the historical growth rates from 1960-2005 (solid bars) and the 75-year projections for 2005-2080. The first set of bars shows overall growth in real GDP. Historically, that has run about 3.5 per cent per year, which means GDP doubles every 20 years or so. In the intermediate projection, growth drops to under 2 per cent. That might not sound like a lot, but it means GDP takes about 35 years to double. If you go back over the last century and a half, you will not find a 75-year period with growth this low.

Even the most optimistic, or ‘low cost’ projection of the Trustees looks fairly gloomy. The growth rate of GDP drops by about a full percentage point.

GDP growth can be decomposed into two main components: the growth of employment, which is just the number of workers, and the growth of productivity, or output per worker, so the rest of the chart shows these components. The projections for productivity growth are not that dramatic, and the most optimistic assumption has productivity growth remaining at its historical average. Almost all the pessimism in the Trustee’s projections is carried by their assumption that employment growth will head south in the

next 75 years. In the most pessimistic scenario, employment growth actually turns negative at the end of the projection period. Even in the optimistic scenario, job growth drops by 100 per cent, from about 1.6 per cent per year to only 0.6 per cent per year.

The Trustees assume that the unemployment rate stays fairly constant, so these projections also apply to the growth of the labor force. If you take the standard view held by economists that in the long run, growth is determined by labor resources (adjusted for productivity), then it is clear that the Trustees are anticipating that we are about to enter an era of unprecedented labor shortages. Partly that reflects what is happening to the natural increase in population through births. The birthrate has fallen to the replacement rate of 2 children per female. The intermediate projection has it falling slightly more, the low cost projection has it rising slightly, but both are pretty pessimistic about the labor force growing because of more babies. They also assume that the historical increase in labor force participation by women is pretty much over, and that we can expect little in the way of labor force growth from increasing the ratio of workers to population. The major remaining source of labor force growth is immigration.

Here the Trustees make some spectacularly pessimistic projections, which I've chosen to highlight with a separate chart. Since the 1960s, the number of legal immigrants has been steadily increasing by about 2.5 per cent per year, from around _ million a year to around _ of million legal immigrants and perhaps _ million illegal immigrants, for a total well above one million. During the 1990s, it has been estimated that over half the growth in the labor force was accounted for by immigrant workers. The Trustees project that this historic trend is going to end rather abruptly, with the number of immigrants leveling off, or even falling in the intermediate and high cost projection. The intermediate projection has total immigration falling to 900,000 per year. Their justification is that current policies do not support higher levels of immigration, and they must stick to current legislation in their projections. But that seems unrealistic, and the independent

Technical Panel on Methods and Assumptions of the Social Security Advisory Board, which monitors the Trustees and makes periodic recommendations, has formally questioned this assumption.

An alternative view that I find attractive is that in the long run, growth is not limited or constrained by the available labor force, but that instead, it is more correct to say that the labor force adjusts to match the jobs available. The U.S. economy can be seen as drawing in workers from the global reserve armies of labor. It can draw in more workers with almost no upward pressure on wages, as it did during the 1990s Clinton boom years. The technical term for this situation is that growth is 'endogenous' because variations in the rate of national saving have the ability to translate into variations in the rate of capital accumulation without running into labor shortages. This alternative view seems to be confined to the heterodox fringes of the economics profession, made up of economists who have synthesized the classical traditions of Adam Smith, David Ricardo, and Karl Marx with the macroeconomic theory of John Maynard Keynes. This alternative viewpoint, to which I subscribe, makes me more receptive to the view that growth will probably continue at historical rates, despite the unfavorable demographic trends such as the low fertility rates that we discussed earlier. My best guess is that the optimistic or low cost projections of the Trustees are at least within the realm of possibility, in which case, the system may actually be solvent and may become partially funded even if we do nothing.

But most economists and policy analysts seem to believe that the intermediate projection is more probable, and this has become the benchmark or standard against which policy proposals are evaluated by the cognescenti. There is an irony here that has not gone unnoticed by critics of the Administration. If we are facing an era of unprecedented slow growth in the labor force, i.e., an era of labor shortages, then we should also be expecting wages to rise and profits to fall, both as a share of the national income. As my advanced macroeconomic students are well aware, that is the

prediction of just about any growth model that assumes that labor supply is the limiting factor on long term growth. But if that is true, then what about the promises that individual accounts will be able to generate returns in the 6-7 per cent range that stocks enjoyed over the last century. Those promises are empty. On the other hand, if stocks do continue to generate returns of 7 per cent, that will only be because the growth slowdown has not materialized. In which case, social security will most likely be solvent and even partially funded indefinitely, and the 'problem' that individual accounts were supposed to fix will have solved itself.

Now fixing the solvency problem for social security under the fairly gloomy conditions of the intermediate projection is not all that difficult. It can be done with modest increases in taxes, or modest reductions in scheduled benefits, or some combination. The Trustees report that the actuarial deficit over the 75-year planning horizon is about 1.9 per cent of payroll, meaning we could achieve solvency with a two percentage point increase in the payroll tax, bringing it to 7.2 per cent for workers and 7.2 per cent for employers.

There are several plans on offer that provide an array of tax increases and benefit reductions. The most thoughtful is probably Peter Diamond and Peter Orszag's "balanced approach" Their approach raises the cap for payroll taxes in recognition of the fact that income inequality has grown substantially since 1983, when the cap was established. It adjusts taxes and benefits by means of a formula which indexes them to average life expectancy.   But their approach has not attracted much attention outside the Beltway, and most of the attention is now focused on the Bush Administration.

Is the Bush plan a good deal for younger workers?

At this point, let me speak about why the Bush plan is a bad deal for younger workers. As we have seen, the privatizers are dangling the carrot of 7 per cent returns in front of us. Suppose I

am right, and we are not facing an era of unprecedented labor shortages, and that growth will continue at historical rates. Will individual accounts be a good bet?

The devil, as they say, is in the details. The Bush plan offers workers the option of putting about 1/3rd of their payroll taxes into individual accounts (with a cap that is phased in gradually). In return, workers will forego scheduled benefits of an equivalent amount, calculated with a 3 per cent real rate of interest. If a 20-year old worker puts $1 into her account today, her benefits will be docked by around 4 inflation-corrected dollars when she retires in 47 years. That is, 1.03 raised to the 47th power. So this deal only makes sense if your individual account earns over 3 per cent.

If stocks and bonds earn yields at historical rates, then clearing this hurdle will not be hard on average. But there is no guarantee, because markets fluctuate, often spectacularly as in 2001. If you happen to retire in a bad year, you may walk away with retirement benefits that are substantially lower than the benefits of those of your friends, who happen to retire a year ahead or behind you. The Administration contends that workers will be exposed to minimal risk because they won't be able to 'play the market' but instead will be restricted to a small number of standardized accounts modeled after the Thrift Savings Plan which services Federal government employees. The TSP offers a few highly-diversified stock funds, some bond funds, and one product called a 'life cycle fund' which automatically rebalances you portfolio as you age, starting you out with mostly stocks and slowly moving toward all bonds as you near retirement. This is standard financial planner advice: stocks have higher returns, but are risky, so we should be doing this as our tolerance for risk decreases closer to retirement.

It turns out that even the life cycle fund carries with it a risk that your return will fail the 3 per cent test. Robert Schiller, the Yale financial economist who actually coined the term 'irrational exuberance' that Alan Greenspan got credit for, has constructed a simulation model and shown that even over the last century, with

good returns on average, a life cycle fund would fail the test 30 per cent of the time.

Now if you are a high-wage earner, the chances are you already have a portfolio of assets that has been designed to deal with risk. You can afford the luxury of making this bet with your individual account, by simply shifting some of your portfolio into safer assets to compensate. But most workers are not in that position. They can not, or should not, take on more risk. They need the security of having in their portfolios a solid social security asset backed up by the defined benefit.

In fact, most workers need that solid asset in their portfolios even more than ever because their world has gotten riskier. The most relevant way this is true is that beginning around 1980, companies began shifting away from the traditional defined benefit pension plan, toward 401(k) and other defined contribution plans. DB plans give you a scheduled benefit, usually a fixed percentage of your end-of-career earnings. DC plans give you the returns on your contributions, which are risky. By the 1990s, most retirement wealth held by workers had switched to DC, according to the Federal Reserve Flow of Funds Accounts, where these aggregates are tracked.

One of many ironies of this whole debate is that the privatizers have (correctly) pointed out that as a PAYGO system, social security can only provide a rate of return tied to the growth rate of the taxable payroll, with adjustments for administration costs and other complexities. Social security Administration actuaries calculate that that return will be around 1.7 per cent for the average 20-year old worker. But the Bush Plan docks you as if you were getting 3 per cent. This is not a good deal for individual young workers, and if we believe the polls, they are not buying it.

But individual accounts are really just the tip of a big iceberg, and we ought to ask what's below the surface. Where did privatization come from? Like many conservative policy initiatives, it has

descended, with modification, from Milton Friedman's 1962 book Capitalism and Freedom. Friedman advocated making social security a means-test system with a mandated insurance component supplied by the private market, much like auto insurance. Privatizers have kept this dual structure well in mind. In a recent debate at the Ethical Society of New York, Michael Tanner of the libertarian Cato Institute asks rhetorically: "Do we want a system, basically, that turns our retirement over to politicians, or do we want a system that ensures that there is a safety net that will take care of those people that fall into legitimate hardship, and who cannot take care of themselves, but where the rest of us have the choice and freedom to save and invest for ourselves?"

The iceberg consists of a two-tiered retirement system. One part will be a basic (possibly means tested) benefit targeted at poverty in old age. The other will be a glorified 401(k). On the surface, this may sound like fine idea. People often complain that the existing system gives generous benefits to very well-off retirees, who don't need them. But that is the inevitable result of having universal social insurance: it covers everyone, even the rich. The problem with Balkanizing social security along Tanner's libertarian lines is that the core social security benefit would devolve into welfare for the old poor. And an old adage says that in America, programs for poor people are poor programs. That's because they lack a politically powerful constituency. The rich, who do not lack for political voice in this country, would begrudge the taxes that support such a program and it would atrophy. The devolution of AFDC into TANF is an object lesson. The architects of social security were prescient when they insisted that the system be universal, for other wise it cannot be social insurance.

Of course, we do not have a plan from the Bush Administration that outlines their version of the iceberg. But we do have the recommendations of the Bush-appointed Commission to Strengthen Social Security. Its Plan 2, which is widely regarded as the most likely template for an Administration proposal, achieves

fiscal balance by switching from wage-indexing benefits to price-indexing benefits. That means that instead of giving each generation a benefit that reflects the increases in our national living standards, we will freeze benefits at the real level. Over time, as productivity and wages increase, social security as a fraction of wages, the so-called replacement rate, will drop from around 40 per cent today to around 20 per cent by mid-century, when today's 20 year-olds retire. That is how social security will be demoted from an important leg on the fabled 3-legged stool of retirement planning to a basic benefit targeted at relieving poverty in old age, just as Tanner outlined in a moment of candor.

Is there a better alternative?

The best way to understand how a PAYGO system works is to think of it as a 'chain letter' or Ponzi game, which it is in a technical sense. (Charles Ponzi was a Boston financier who was sent to prison in the 1920s for setting up a chain-letter style swindle. He was deported and wound up as a treasury official in Mussolini's government. He has been immortalized by lending his name to this category of unsustainable financial structure.) The only way participants get any return on their contributions is if new participants join after them. As long as the population and overall employment are growing, the natural conditions prevail for social security to run as a sustainable Ponzi scheme. This fact was proved formally by Paul Samuelson in the 1950s. Sometimes critics of social security call it a Ponzi game in a pejorative sense, yet there is really nothing unsustainable about the return it provides. But the return you get on your tax contribution (measured by the excess of benefits over taxes paid in) is strictly limited, as Samuelson showed, to the growth of the wage base, which means the growth rate of employment plus the growth rate of real wages. As I have already mentioned, that is fairly low in the U.S. There is a fairly sizeable technical literature about measuring this rate of return, by the way, and it has come to be known as the "money's worth" of social security. As we have

already seen, its low level has been a major complaint of conservatives and privatizers.

All this applies to a mature PAYGO system. But the first generation in a PAYGO system reaps a bounty because they get benefits without having paid much in taxes. The poster child here is the very first beneficiary, Ida May Fuller of Ludlow VT, who paid in about $25 in taxes but received around $22,888 in benefits from 1940 till her death in 1975 at the age of 100. The social security system took several decades to mature, and retirees were reaping high returns (though obviously not as high as Ida May's!) right up until the 1980s and 1990s. One of the reasons we now have a political movement calling for privatization is that the fairly low returns of a mature system have materialized in the last two decades. The conservative complaint that social security is a forced saving plan with a sub-par rate of return now reaches a receptive audience, especially among younger workers.

One response to the conservative complaint is that this is an apples to oranges comparison. Social security is not a pure retirement system. It provides comprehensive social insurance, covers disability, provides spousal benefits and survivor benefits to dependents. If you include the value of the insurance coverage, its effective money's worth is several times the financial money's worth measured by the actuaries and economists. And that is right. But we need to be aware that as long as people are forced to pay FICA taxes, they will make this comparison, and conservatives will use this comparison to snipe at the system and undermine its legitimacy. The 'apples to oranges' defense, in other words, is technically correct, but politically ineffective. Defenders of social security need a better defense, and I think prefunding is the starting point to mounting a better defense.

Prefunding social security overcomes the money's worth problem. The best way to see how is to think of the trust fund as being like a college endowment. An endowment provides financial returns that subsidize tuition. A college with a large endowment can offer the

same educational services for lower tuition. The trust fund's returns subsidize payroll taxes. A large trust fund enables social security to pay the same benefits with lower taxes (or higher benefits with the same taxes, or some combination.) Its been estimated that the current benefit structure would require a payroll tax rate 2-3 percentage points lower if the system were funded. In other words, the rate of return on social security taxes, its money's worth, increases with the funding level.

Full funding is defined as the level of funding that equates the money's worth to the market rate of return on private assets, like stocks and bonds.   Between PAYGO and full funding lies the region of partial funding. Beyond full funding, you enter a region of overfunding or superfunding. A superfunded social security system gives workers a rate of return that exceeds the market rate of return.

My final figure illustrates the point that the money's worth of social security rises with the funding level, reaches the market rate at full funding, and rises above it with superfunding.

What this figure dramatizes is the advantage to workers of achieving any level of prefunding.   But the figure relates to a mature system, not one making the transition from, say, PAYGO to full funding. To make that transition, someone has to provide the prefunding. If the funds come from payroll taxes, then the transition generation winds up paying doubly because it has to finance the benefits under the old PAYGO system as well as put in money for its own retirement. This is the same transition cost that bedevils the Bush privatization plans, and which they propose to cover through borrowing. Prefunding by using payroll taxes has long been a goal of conservative economists like Martin Feldstein.

But there is no reason why we should restrict ourselves to the payroll taxes as a revenue source. In fact, in the original conception of Social Security, in the 1930s, the architects envisioned a three-way funding plan, with workers, employers, and

"the government" (meaning general revenues) providing equal amounts of finance. That plan was dropped during the 1940's. It was revived, albeit inadvertently, by the Clinton Administration when they discovered that they were facing budget surpluses during the 1990s. To some extent this was the result of the OBRA93 tax increases; but it was combined with robust growth and a stock market boom that were largely unanticipated. Clinton responded with the slogan 'Save social security first' and proposed to devote the surpluses to paying down the national debt and strengthening the social security trust fund. The basic idea was to achieve some level of prefunding using general revenues, mostly consisting of individual and corporate income taxes that are very progressive.

As we all know, the election (or appointment) of the Bush Administration put an end to budget surpluses. Bush's fiscal policy has involved one tax cut for the rich after another, and we now have some serious fiscal deficits staring us in the face. But progressives and supporters of social security ought to be thinking ahead to better days when we can put in place an alternative program based on returning to the basic Clinton plan.

And in my opinion it doesn't make any sense to think only in terms of what is possible in the current political climate. We can learn a lesson from Milton Friedman, who proposed privatizing social security in 1962, and was mostly dismissed as a right-wing crank. He also proposed school vouchers, in the same book, Capitalism and Freedom, and was dismissed for that, too. Today, no one is laughing at either one of those proposals just because they were not possible in the political climate of the 1960s.

So here is my proposal. First, we need to revoke the Bush tax cuts for the rich, and restore the progressivity of the income tax to the status quo ante, before Bush. Restoring fiscal balance or even on -budget surpluses, would be central to any plan to prefund social security.

But we should probably be thinking about supplementing the income tax with other sources of revenue that are specifically designed to redistribute wealth from the top 1 or 2 percent toward the trust fund. One idea, put forward by Peter Diamond and Peter Orszag, would be to reform the estate tax, rather than bagging it as Bush has proposed, and dedicating it to social security. The estate tax does fall on the wealthiest 2% households, but it doesn't raise much revenue. To really make a dent in funding social security, we will probably need to initiate a new tax on wealth. *Ed Wolff, in a terrific little book called Top Heavy, surveyed the tax systems of the world and found that the U.S. is really unique in not taxing wealth at the Federal level (we obviously tax real estate wealth at the local level). He estimated that if the U.S. adopted a modest wealth tax modeled after the Swiss system, it would raise around $50 billion a year, and if it adopted a more aggressive wealth tax structured like the Swedish system, it could raise about $725 billion a year. Both these systems are progressive, have fairly generous thresholds before any tax is paid, and cover wealth fairly broadly. The Swedish system's highest rate is 3 per cent while the Swiss system only goes up to 0.3 per cent.* Since the goal is funding social security, rather than using a wealth tax to pay current benefits, it would make sense to set a time limit on a wealth tax, so that it has the character of a capital levy. That will minimize its effects on new capital formation and saving, because it will mainly be a tax on existing capital. A new national wealth tax could be dedicated to the task of advance funding social security, and recorded in the off-budget balance.

As I have already indicated, a policy of advance funding social security will require that budgetary rules are in place so that the social security surpluses actually contribute to higher national saving. The practice of de facto targeting the unified budget will have to be replaced with a policy of targeting the on-budget balance. That way, the off-budget, social security surplus will be able to contribute to overall government saving and ultimately to national saving. By the way, let me be clear that it is important to implement budgetary rules flexibly, so that fiscal policy remains a

countercyclical tool for combating recessions. In practice, that would mean targeting the on-budget balance averaged over the business cycle.

How much prefunding will it take to achieve a fully funded system? In 2004, social security benefits were around $500 billion. At the roughly 3 per cent real interest rate on Treasury bonds that the trust fund earns, it would take around $9 trillion to generate enough returns to pay those benefits, which is the defining feature of a fully funded system. But it would not be sensible, or probably even feasible if the government has been running surpluses and paying off the national debt, to invest in Treasuries. It would be necessary to diversify the trust fund into private stocks, bonds, and other financial assets, and that would generate a higher return. A portfolio of 40 percent stocks and 60 percent bonds, earning roughly historical real rates of 6.5 on stocks and 3 per cent on bonds, would generate a 4.5 per cent return and require about $7 trillion in the trust fund to achieve full funding. The Trust fund already has around $1.7 trillion in it, so this would require about $5.5 trillion to top it up and achieve full funding. All these are just "back of the envelope" calculations intended to give you a sense of the orders of magnitude involved in prefunding social security.

For purpose of comparison, the household sector at the end of 2004 had net worth, which is assets minus liabilities, on the order of $45 trillion dollars, held in the form of stocks, bonds, pension wealth, real estate, and other items offset by loans and mortgages. Ed Wollf has updated his estimates from Top Heavy, and reports that around 2000, the wealthiest 1 per centile held about 33 per cent of the net worth, and the wealthiest 5 per centile held almost 60 per cent of net worth. That means the top 1 percentile has a net worth around $15 trillion dollars, and the top 5 percentile around $27 trillion. A progressive wealth tax, in other words, could conceivably achieve a substantial amount of prefunding mainly by transferring wealth from the richest households. But these are huge transfers, and aside from the economic questions they raise,

they clearly call into question the political realism of such massive Robin Hood fiscalism. Suffice to say that a government intent on funding social security will need plenty of political will and strong grassroots support.

A big economic question is what effect would taxation like this have on the behavior of the rich. Would they stop saving and investing ? This question is harder to answer than it seems. The best effort to study the effects of taxes on the behavior of the wealthy is a book edited by Joel Slemrod titled Does Atlas Shrug? (a reference to Ayn Rand's book, Atlas Shrugged, which is about a strike by the wealthy and talented against creeping statism). The overall conclusion, summarized by Slemrod's introductory chapter, is that: "In the face of substantial tax rates . . . , the rich appear not to alter significantly either their supply of labor or their portfolios." At the end of the day, though, we know little about how the wealthy respond to taxes of the sort we are considering here.

We do need to remember that a policy of prefunding social security adds directly to national saving. While the wealthy may reduce their saving in response to a tax on their wealth, the reductions will not be dollar for dollar. But the tax revenues are 100 per cent saving, so the net effect is to increase national saving. I worked this out in a paper written with Duncan Foley, published in the Cambridge Journal of Economics last year. We showed that prefunding social security using a wealth tax would contribute to economic growth, and result in a permanently higher level of the capital stock, jobs, and GDP.

Incidentally, we also found that this policy would increase the amount of saving that working families could afford and raise their share of the nation's wealth. In other words, prefunding social security's trust fund actually encourages an 'ownership society' to borrow Bush's favorite phrase. The reason is simple. Prefunding increases the lifetime wealth of working families by lowering the payroll taxes needed to finance a given level of social security

benefits. With more take-home pay, workers will save more (as well as consume more).

The underlying assumption in the CJE paper was that growth is not limited or constrained by the availability of labor—i.e., endogenous growth. For a large, high-wage country like the U.S. this does not seem too far from the truth. We enjoy access to the labor reserves of the world through immigration, and if we are growing faster as the result of the increased capital formation stimulated by prefunding, some of the new jobs will be filled by additional immigration. From this perspective, the most likely future scenario would be more like the Trustee's 'low cost' alternative in which growth does not slow down. As we have seen, in this scenario, solvency never becomes an issue.

At the other extreme, it is possible that we are in fact entering an era of labor shortages—i.e., exogenous growth. So I have worked out the analytics of this prefunding plan in an exogenous growth setting as well. In this case, increasing the rate of government saving through an advance funding plan can not add to the nation's capital stock very much. Instead, it will tend to create an incipient excess demand for labor that will drive wages up and profits down. This period of policy-induced profit squeeze will crowd out the wealthy (who rely heavily on their property income), and they will wind up owning less capital than they would have otherwise. Obviously, the government will wind up owning more capital, accumulated in the trust fund. Since the government represents the citizens, most of whom are working people, this policy will redistribute the ownership of wealth indirectly to workers in their capacity as citizens. And by crowding-out the wealthy, it will increase the share of the capital stock that is owned by workers through their lifetime saving (which economists call life-cycle saving). So even if advance funding fails to add to the nation’s economic resources, it will democratize the distribution of claims to the economic surplus that takes the form of business profits. Workers will be better off in the long run because they will receive

a higher money's worth on their social security, through the arithmetic of funding that we rehearsed previously.

I think its important to emphasize that we don't and can't know which of these scenarios—endogenous versus exogenous growth--about the next century is most nearly true. So a policy of advance funding can be viewed in terms of a best case/worst case approach. It would make sense to choose a target level of funding, or perhaps even superfunding. In the best case, growth is endogenous, and we are not entering an era of labor shortages. The government can even contribute to higher growth by prefunding social security. In the worst case, growth is (or becomes) exogenous, and we do enter an era of labor shortages which put a ceiling on capital formation. Prefunding social security will not add to growth, but it will lead to a redistribution of wealth that is broadly beneficial to working families. We may target a level of funding, but as we enter the era of labor shortages find that we are forced to spend some of the surplus just paying scheduled benefits. In this case, though, the policy of prefunding will have prevented the insolvency of the system as projected under the Trustees' intermediate and high cost scenarios. We may, for example, shoot for full funding but have to settle for partial funding in this worst case.

The main objection I have encountered to this kind of policy has come from Keynesian economists like Thomas Palley, who are generally skeptical that fiscal surpluses, which is what government saving is, could generate any growth since these are inherently contractionary in nature. The modern Keynesians, in other words, subscribe to some version of the paradox of thrift, in which efforts to increase national saving are generally self-defeating because, in their theory, the level of saving is determined by the level of investment, and not the other way around. They say there is no guarantee that investment spending will increase enough to validate a higher level of national saving. That theorem makes good sense as a description of the short-run behavior of modern economies, but there is considerable controversy about whether it extends into the long run. Among the mainstream in the

profession, it is almost universally and uncritically accepted that the paradox of thrift is at most a purely short run problem, but among the heterodox economists that maintain strong links to the intellectual tradition of Keynes, this is a continuing and lively controversy.

My own belief is that in the long run, the economy operates along classical lines, and that the paradox of thrift is a short run issue, as the mainstream maintains. Here the standard policy prescription has always been to get the policy mix right: a tight fiscal policy (i.e., fiscal surplus) needs to be offset by a suitably loose monetary policy in order to generate investment and other demand, to replace the spending reductions which go along with tax increases. This is the policy mix that was supposed to underwrite the Clinton Administration's deficit reductions. However, if you go back and look at what the Fed actually did with interest rates in the 1990s, you'll see that in real, inflation-adjusted terms, they were not particularly low relative to the historical values. So I think that if we were to put a policy of fiscal surpluses devoted to prefunding social security into place for extended period of time, as I am proposing, it would require some vigilance over the Fed to make sure they came up with an appropriately loose monetary policy. Without that, I'd have to agree with Palley that fiscal surpluses are risky from a Keynesian, aggregate demand perspective.

The other main objection to prefunding the social security trust fund comes from conservatives who are worried about government ownership of stocks. In fact, since they agree in principle to the desirability of a prefunded system, this is the main reason that conservatives have chosen to back individual accounts. If social security were fully funded in 2004, and if the trust fund were invested exclusively in the stock market, the U.S. government would be the owner of about half the market value of the corporate sector. Interestingly, through state and local government retirement funds, the government sector already owns almost 10 per cent of domestic corporate stock. The conservative complaint is that government ownership creates opportunities for political

intrusions into corporate governance, for example, through efforts to divest from anti-social activities like tobacco stocks, or stocks of companies that engage in anti-union activity, child labor abuses, and the like. The conservative economists have tried to show that this has lowered the returns to the state/local retirement funds, although there are also studies on the other side. This was a hot topic in the late 1990s, because at that time it looked like the U.S. government would run surpluses long enough to pay off the national debt, at which point it would have to begin accumulating private securities.

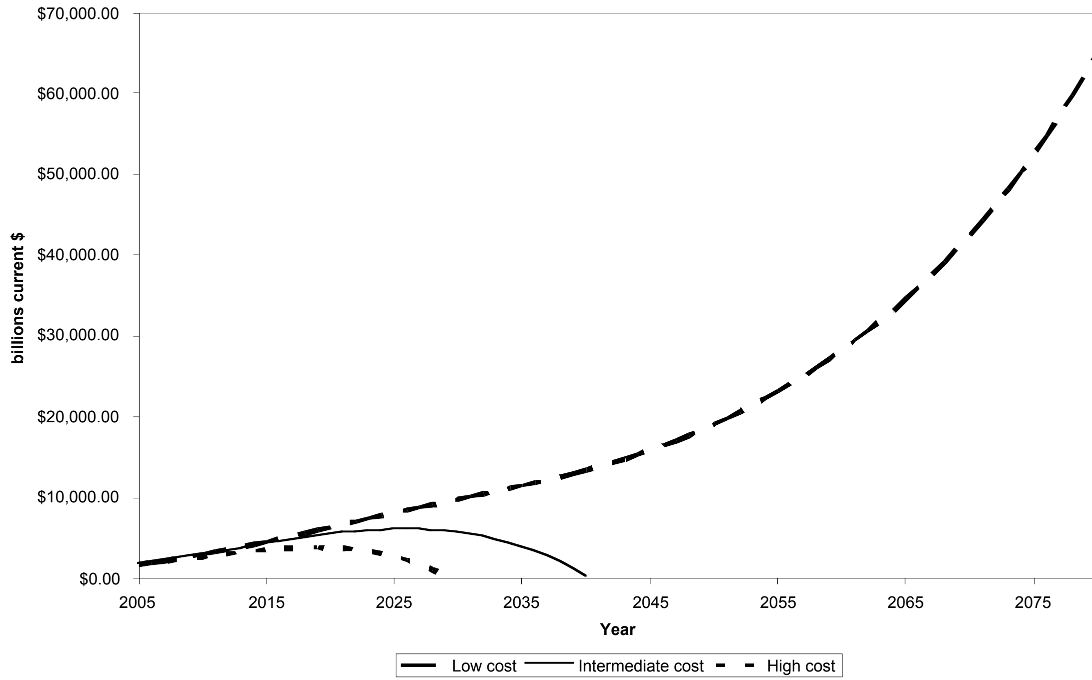
The first line of defense against this complaint is that it is possible to design an investment plan for the trust fund that insulates it from corporate governance. The Thrift Savings Plan provides a model here. Its assets are invested in index funds which passively reproduce a market index, such as the S&P 500, the Wiltshire 5000, or the Lehman bond index. Moreover, the investments are managed by private sector financial institutions that bid competitively for the contracts to manage these funds. This insulates the TSP from any corporate governance issues, and the index-fund structure precludes any political influence over investment strategy. There is no reason why an expanded and diversified social security trust fund could not model itself on this well-respected example.

The second line of defense, however, is to say: So what? Isn't that what economic democracy would look like? If we achieved public ownership over half the corporate assets, wouldn't that give the citizenry a greater incentive to scrutinize the business enterprises they have a stake in? We have seen concrete examples where the stockholder activism of Calpers, the largest state retirement fund, has improved corporate governance. And who could argue, after the Enron, World Crossing and other scandals of the 1990s, that corporate governance does not stand in need of improvement.

At this point, I have probably stepped into the Twilight Zone for most of you, so let me do a quick reality check to end this talk.

History teaches us that progressive changes occur because the ideas are put in circulation by visionary leaders and because masses of people rally around them and put pressure on the ruling elites to effect changes.

My father used to tell me that we have social security because it was first proposed by Norman Thomas, the Socialist candidate for President. Even though he had no chance of winning, his ideas eventually made their way into the political culture. During the 1930s, two populist political movements put pressure on the Roosevelt Administration. The first was the Townsend Plan, basically a form of PAYGO social security, and the second was Huey Long, the colorful Louisiana senator, whose slogan was 'every man a king.' Long favored some fairly wild measures to redistribute wealth. In fact, if you look at the history of social security, it turns out that the first plan was instituted by the Iron Chancellor, Otto von Bismark, as a way to win German workers away from the rising socialist party in the late nineteenth century. Right now, we are clearly experiencing a low point in terms of populist or progressive political sentiment in the U.S., but we can certainly hope and expect to see the pendulum swing the other way. And when it does, we need to stand ready with concrete programmatic ideas. I'm not sure that prefunding social security makes a very good slogan for a banner or picket sign. But the idea of using the social security trust fund as a vehicle for redistributing wealth in a progressive direction could well become a central organizing principle for a revitalized populist, progressive movement of working families in America. If it succeeds, Social Security will then be an even better deal for young workers than it is today.



OASDI Trust Fund Projections
$70,000.00
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$50,000.00
$40,000.00
$30,000.00
$20,000.00
$10,000.00
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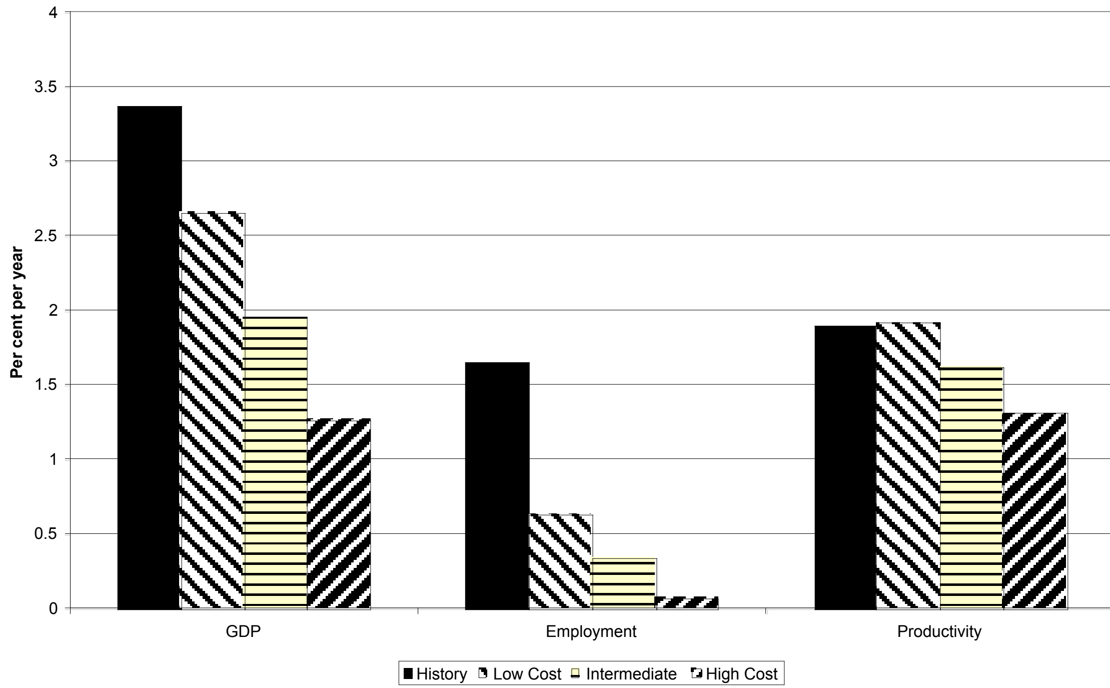
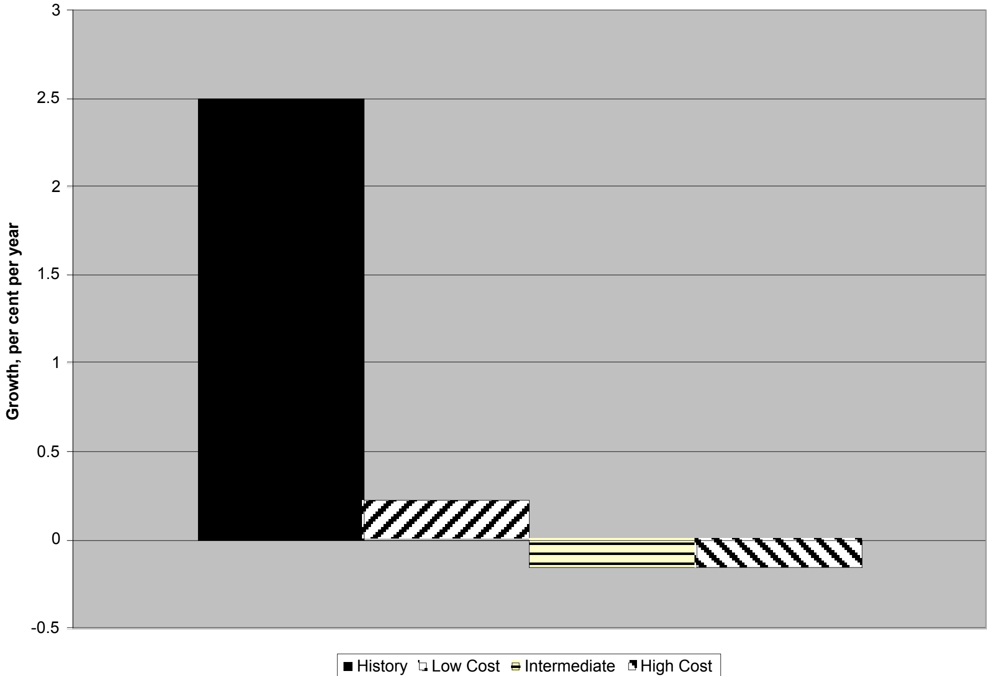
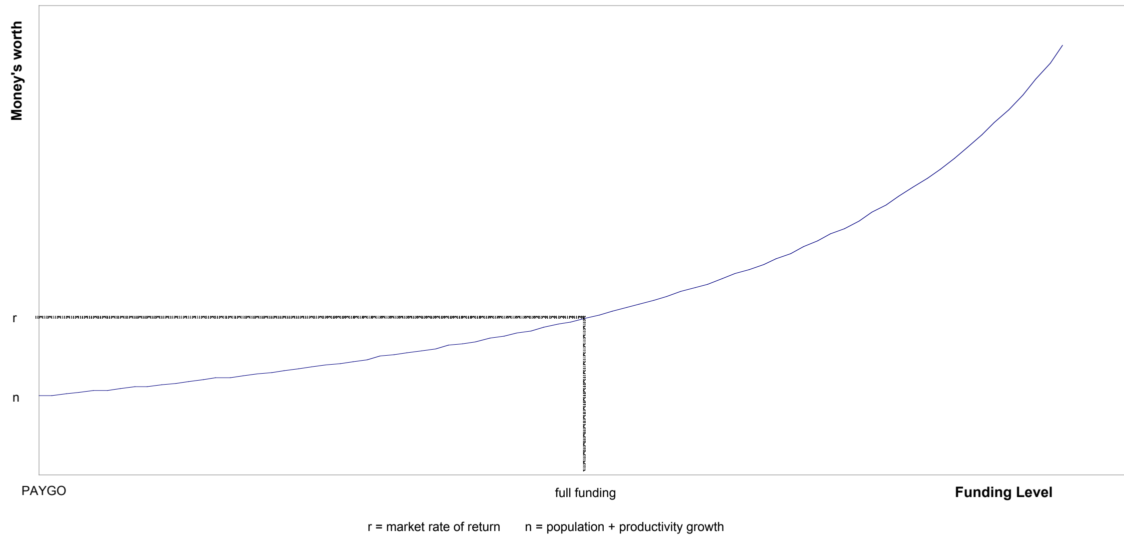
billions current $
2005
2015
2025
2035
2045
2055
2065
2075
Year
Low cost
Intermediate cost
High cost


Trustees' Economic Assumptions
Per cent per year
4
3.5
3
2.5
2
1.5
1
0.5
0
GDP
Employment
Productivity
History
Low Cost
Intermediate
High Cost



Trustees' assumptions about immigration
Growth, per cent per year
3
2.5
2
1.5
1
0.5
0
-0.5
History
Low Cost
Intermediate
High Cost


Funding and Social Security Money's Worth
Money's worth
r
n
PAYGO
full funding
Funding Level
r = market rate of return
n = population + productivity growth