

SOCIAL SECURITY SOLVENCY: A CRISIS?

By JOHN LAITNER *

Introduction

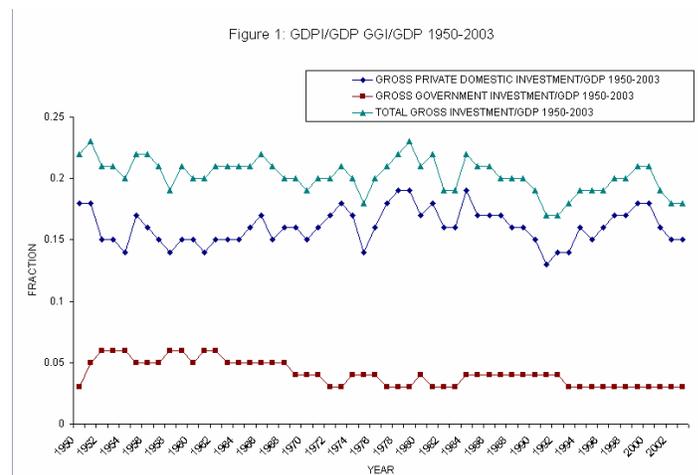
Social Security has become a topic of national conversation; politicians and news media are widely discussing the need for, and possible shape of, Social Security reform. The basic factors leading to the necessity of policy change are evident: fertility has gradually declined and longevity increased; thus, the number of older Americans relative to those of working age has risen, and these trends render a pay-as-you-go pension system unable to continue to deliver benefits at previous levels of generosity without additional revenues. This brief first attempts to survey the backdrop of the present economic situation more broadly than just demographics. After setting a context in that way, it suggests a two—part answer to the question in its title. Finally, it briefly discusses the relation of one frequently mentioned possible reform, the introduction of personal accounts, to Social Security's current difficulties.

Background

Advocates of reform often associate needs to change the Social Security system with deficiencies in U.S. saving behavior and/or with government budgetary problems in general. It is now widely known that the Social Security system is approaching a time when revenues from the current level of payroll tax will not be sufficient to cover benefits owed. Less well known, perhaps, are facts about the national economy as a whole. As we continue to discuss reform options, it is important to keep this larger context in mind since it may influence specific policy choices.

Turning to the overall economy, output per worker – a good measure of the standard of living that the economy can deliver – depends primarily upon physical capital per worker, the state of technology, and so-called human capital (i.e., education, training, and experience) per worker. I focus here on the first. Domestic physical capital comes from domestic investment spending on the part of the private sector and the government. Investment, in turn, must be financed with saving.

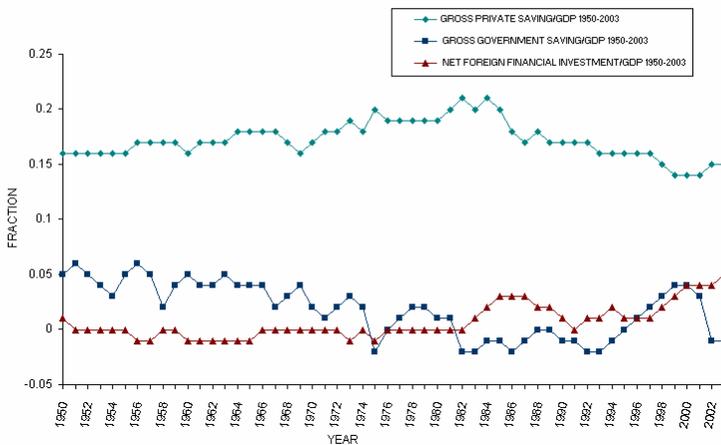
Figure 1 shows that domestic investment as a share of total output (i.e., GDP) has fallen slightly over the last 50 years, from about 22 percent to about 20 percent. The entire decline, however, comes from a fall in government investment; private investment spending has remained the same. Perhaps building the national highway system and numerous public schools to handle the baby boom created special governmental in-



vestment needs in the post WWII years. On the private side, the picture seems quite stationary.

Since a dollar's worth of saving must finance each dollar of investment, total investment must equal total saving. Total saving is the sum of three components: domestic private saving (from businesses and households), government saving, and net foreign financial investment (the last consisting of saving on the part of foreigners that flows into U.S. capital markets and purchases U.S. assets). Figure 2 shows that domestic private saving as a share of GDP has trended down over the last 25 years in the U.S. Nevertheless, prior to that,

Figure 2: Gross Private Saving as a fraction of GDP, Gross Government Saving/GDP, and Net Foreign Financial Investment/GDP



private saving trended upward. In the end, perhaps surprisingly, domestic private saving remains about as large a fraction of GDP today as it was in 1950.

The figure shows, on the other hand, that government saving – the excess of tax revenue over current government spending on transfer payments and consumption – has trended downward, from a share of GDP of about 5 percent in 1950 to -1 percent recently. Since investment has not changed nearly as much, inflows of foreign saving (i.e., net foreign financial investment) must have made up the difference. Indeed, Figure 2 shows that inflows of foreign saving have risen, especially since 1980.

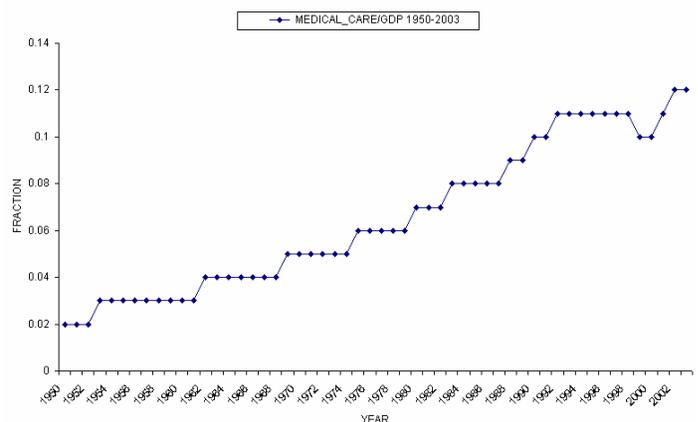
In sum, U.S. domestic investment in physical capital – in particular, privately owned physical capital – has proceeded at a steady long-term pace over the last five

decades. The U.S. has, however, begun relying increasingly on foreign sources of financing for its investment. To the extent that foreigners accumulate U.S. government bonds through their financial investments, U.S. taxpayers will owe them interest in the future. To the extent that foreigners acquire private securities, future dividends, interest, and capital gains will accrue to them. One wonders as well whether foreign owners of U.S. businesses will want to hire Americans to top management positions or whether the U.S. will begin, in a sense, to lose control over a portion of its business sector.

As an aside, low government saving has led to increases in the Federal debt, the so-called national debt. The ratio of the Federal debt to the GDP was 1.18 in 1945, after enormous wartime spending; it steadily fell until about 1981, reaching a low of .33 in that year; but it has risen subsequently, reaching about .63 in 2003.

Finally, Figure 3 shows medical expenditures as a share of GDP. The share rose from under 3 percent in 1950 to 12 percent and more recently. The *Economic Report of the President 2004* projects that the Federal budget deficit, in the absence of corrective action, will expand by 2080 to 200 percent of the present budget's share of GDP. The three budgetary components that account for most of the problem are Medicare, Medicaid, and interest on the national

Figure 3: Medical Care as a Share of GDP 1950-2003



debt. Federal medical spending is about as large as Social Security benefit payments now; the *Economic*

Report of the President 2004 projects that medical spending will be about twice as large as Social Security benefits by 2080. Large increases in medical spending have accompanied the decline in government saving in recent decades, and it is difficult to believe that government saving can be restored to previous levels without progress in limiting rates of increase in Medicare and Medicaid expenditures.

A Crisis?

It seems fair to say that the U.S. Social Security System faces a "serious" solvency problem in this century. It also seems fair to say that discussions of Social Security frequently advertise possibilities for increasing overall national saving as a key by-product of reform. There are indeed close ties between Social Security and overall saving. On the one hand, the Social Security system surely reduces private incentives to save: e.g., I do not need to save as much for my own retirement if I can expect to receive Social Security benefits. On the other hand, the difference between Social Security tax receipts and Social Security benefit expenditures impacts government saving directly. Recently the latter effect has been to increase government saving. But, longer term the effect will be the opposite – until the system's solvency problems receive attention. If we want to think of Social Security as one element in the larger picture of government saving, that picture, in total, does, to this author, seem to be one of "crisis" – though, as we have seen, fixing Social Security's insolvency would only constitute a start at rectifying the full set of fiscal difficulties that we face.

Reform

Instituting a system of personal accounts has recently been the most widely discussed direction for Social Security reform. This section speculates on the possible role of personal accounts in coping with Social Security's impending solvency problems and in alleviating the U.S. economy's growing dependence on foreign financing.

An earlier paper by the author, entitled "Transition Paths and Social Security Reform," suggests that instituting personal accounts would, as a rough approximation, neither improve nor harm the solvency of the current Social Security system. The existing Social Security system is essentially an unfunded, or pay-as-you-go, defined benefit pension plan. In other words, the present system uses tax collections from workers to pay concurrent benefits to existing retirees. In this framework, any payroll tax collections that reform diverts to new personal accounts will have to be made up from other revenue sources if Social Security commitments to existing retirees are to be met.

Another way of thinking about this issue is as follows. The existing Social Security system, due to its unfunded nature, has zero net worth – it merely directs current flows of payroll tax revenues to current benefit payments to retirees. A functioning system of personal accounts, on the other hand, would have substantial net worth – namely, the sum of all personal account balances. To move from a system with zero net worth to one with positive net worth requires a transition period. If government borrows the money (by issuing new government debt) to pay retirees in the old system so that young people's payroll taxes can fund new personal accounts, after the transition period the increment to national debt will equal the assets in the new personal accounts. In other words, new national liabilities (i.e., new national debt) will counterbalance new assets (i.e., new personal account balances) so that in economic terms, the country's net worth position will remain the same as before.

This implies that there is no panacea for Social Security's looming solvency problems: we need to find new revenues, reduce benefits, or both. Personal accounts may well be desirable on their own merits, of course, but they do not in and of themselves fix the fiscal problems of the existing Social Security system.

One possible approach to reform would look first to the private sector. Private pensions are already undergoing a changeover from defined benefit plans to defined contribution plans. For example, U.S. Flow of Funds tables show that defined benefit plan assets were almost twice as large as those of defined contribution plans in 1985; by 1995, assets were about the same in each; and, by 2003, defined contribution plan assets were a third bigger. In a defined contribution plan, a worker has a personal pension account, he or she contributes to the account regularly, the account is typically portable, the worker typically has latitude over securities in which to invest the account's balance, and the balance plus interest belong to the worker at his or her retirement. Perhaps the regulatory environment can be set to help these plans to flourish. If private sector accounts are low cost, profitable, and widespread, they might in the not too distant future form a platform from which to launch Social Security personal accounts. In the meantime, since private-sector accounts are subject to rate of return risk, the existing Social Security system can provide workers with diversification.

An alternative approach would set a rapid and immediate transition to personal Social Security accounts. Perhaps the initiation of change would provide opportunities for arranging new sources of finance: individuals might be persuaded to increase their private saving to finance balances for the new accounts, or a temporary tax increase might ease the necessity for new government debt. Although the preceding paragraphs argue that as a first approximation, instituting personal accounts would not by itself lead to additional national wealth creation, other authors argue that the approximation is not perfect and that new benefits emerge that could be capitalized into temporary tax revenue sources. Details of the setup of the transition phase would be critical in determining whether new national wealth was accumulated or, indeed, whether existing solvency problems of Social Security were addressed.

Conclusion

Maintaining the present Social Security system is becoming more burdensome over time because of falling birthrates and increasing longevity. Instituting a system of Social Security personal accounts may not by itself solve existing inconsistencies between Social Security revenues and promised benefits. However, the transition period accompanying any large-scale policy change might offer opportunities to increase taxes temporarily or to limit benefits under the old system.

More generally, the Social Security system is only one component of the framework generating saving in the U.S. Over the last fifty years, private saving has held up surprisingly well (though the recent past is less reassuring). Government saving, on the other hand, has declined. That decline seems independent of Social Security, and the decline has led to substantial increases in the national debt. Reforming the Federal budget to restore balance should have the same high priority as restoring solvency to Social Security. This brief suggests that reforming the U.S. system providing medical services may be a necessary part of any overall solution. It seems highly desirable to begin such reform as quickly as possible.

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