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The Security of Social Security Benefits and the President's Proposal

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Abstract

This article considers the Social Security program and President George W. Bush's proposal for individual accounts. The article begins by addressing the nature of the Social Security program's trust fund and explains how the federal government's ability to pay benefits is a function of political will more than the pecuniary intricacies of governmental trust fund accounting. The article then critically examines the components of the long-term financial situation of Social Security, including the use of economic growth rate assumptions that are extremely low by historical standards. It then analyzes several different possible responses, including reallocating governmental expenditures, changing the formula for calculating initial retirement benefits, increasing the cap on Social Security's payroll tax, and raising the retirement age, among others. Finally, the article notes that folks who would prefer to depend on their own individually managed retirement assets have a mechanism already available in the form of the Individual Retirement Account, a mechanism that is superior to President Bush's proposal for individual Social Security accounts in several dimensions.

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By Richard L. Kaplan

In this year's State of the Union Message, President George W. Bush proposed the most dramatic changes to Social Security since that program was enacted in 1935. Given the enormous significance of Social Security to all Americans, this article examines those proposals with particular focus on how they will affect current and future retirees. The article begins by examining the financing structure of Social Security and its anticipated prospects. It then considers various ways to address those prospects, including the President's proposal for individual investment accounts.

Is There a Crisis?

President Bush began his campaign to add individual investment accounts to Social Security by declaring that the present system is "in crisis," "unsustainable," and even "bankrupt." While America in 2005 looks very different from the America in which Social Security originated, that program is neither "bankrupt" nor "in crisis." To understand what is involved, however, requires one to grapple with the intricacies of governmental trust fund accounting, a strange creature with few comprehensible parallels.

The Fabled Trust Fund

Social Security imposes a 6.2 percent tax on an employee's annual wages up to a cap that is increased every year. This year, that cap is $90,000. This tax is then matched by that person's employer. Self-employed folks pay both portions, a total of 12.4 percent of net earnings from self-employment, minus a deduction of half this amount on their individual income tax returns. However these taxes are collected, they are sent to the federal government where they are recorded as receipts by Social Security. The federal government then pays benefits to the full range of Social Security beneficiaries: retired workers, disabled persons who are unable to engage in "substantial gainful activity," current spouses of retired and disabled workers, surviving spouses of such workers, former spouses of such workers (if their marriage lasted at least ten years), and even children of retired, disabled, or deceased workers (within certain age limits).

Social Security's taxes, however, are not physically segregated into some "trust fund," although government accounting records track these receipts as if they were. Similarly, Social Security benefits come from the US Treasury, even though, once again, these disbursements are tracked as expenditures by Social Security's "trust fund." But the main point is that what Social Security is obligated to pay is established by the governing statute and is not limited to whatever balance appears in the program's "trust fund." In this sense, Social Security's "trust fund" is like no other that lawyers typically see. If it actually were "empty," nothing would prevent Social Security from continuing to pay legislated benefits using funds other than those "received" from the program's dedicated payroll tax. Such an eventuality would simply treat Social Security outlays like any other government expenditure: Congress authorizes the collection of federal revenues and appropriates whatever outlays it chooses to pay. After all, even though there is no Pentagon "trust fund," no one has ever intimated that the defense budget is somehow constrained by such artificial budget parameters.

The Trust Fund's Function

The Social Security trust fund does, however, fulfill one important function: it enables the government to get a handle on projected future costs in case a mid-course correction is deemed advisable. In fact, Congress enacted a series of changes in 1983 precisely for this reason, namely, to rectify anticipated "trust fund" imbalances.

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Those changes included raising the age of full retirement from 65 years to 67 years over a 22-year period and also subjecting Social Security benefits to income taxation for approximately the top eighth of Social Security beneficiaries in terms of annual income. And in 1993, Congress increased the proportion of such benefits that would be subject to income taxation, another response to projected "trust fund" imbalances. In other words, the "trust fund" has political significance, but it is not really binding as lawyers would understand that term.

Current Program Surpluses

At the current time, the Social Security program (or "trust fund" if you prefer) collects significantly more money each year than it spends on benefits and program administration. Last year's surplus, in fact, was nearly $152 billion. By law, this surplus must be invested in obligations of the US government; that is, US treasury notes and bonds. In effect, Social Security's net receipts have been loaned to other parts of the government to pay for military expenditures, interest on the national debt, the 75 percent general-revenue contribution to Medicare Part B, the federal portion of Medicaid, roads, law enforcement, and everything else that the federal government provides. Were it otherwise, the federal government would need to raise taxes or increase its already huge borrowings even further to pay its bills. The Social Security surplus, in other words, has been treated just like any other revenue source by the federal government.

I do not mean to imply, however, that such use is unseemly or even unexpected. Quite to the contrary, this practice is required by statute. Moreover, the government has been very faithful in documenting these borrowings from Social Security's "trust fund" and even crediting this "fund" with interest income on those borrowings. Those borrowings, by the way, have the same legal standing as other obligations of the US Treasury and are no less creditworthy than the notes and bonds that are regularly sold to foreign countries and domestic investors.

The Dreaded Crossover Date

At some point in the future, Social Security's annual revenues will no longer exceed that year's benefit payments. According to the nonpartisan Congressional Budget Office (CBO), that date is expected to be 2020. But such long-range forecasts are notoriously inaccurate due to the wide range of variables involved, including future earnings of workers, wars, natural disasters, number of deaths and births, and even the level of immigration, legal or otherwise.

Even more significant, however, is the fact that Social Security benefits can always be paid from some other source of government funds. Such a decision, while thus far unprecedented, is really not beyond the pale, though it would certainly force Congress to make some difficult choices about what programs they want to cut in order to fund Social Security. But such allocations of resources are precisely what Congress is constitutionally required to make. [US Constitution, art. 1, § 8, cl. 1.]

Moreover, in 2020, the accumulated surpluses of previous years will still be in Social Security's trust fund, as well as the interest that has been credited on those contributions. For example, benefits in 2020 are expected to exceed that year's Social Security tax receipts by $16 billion. This is not a trivial sum, even 15 years hence, but it is far less than *that year's* interest income of $206 billion, to say nothing about the anticipated balance in the trust fund at that point of $3.6 trillion. Thus, even if one believed that Social Security should "stand on its own" and not use general revenues, though no other government program lives within this stricture, its benefits would be payable in full, with no diminution whatsoever until the balance in the program's trust fund has been exhausted. According to the CBO, that date is 2052, though once again, projections that far out become increasingly less reliable and are little more than simple extrapolations of current trends. But the point remains that current law

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shows no need to use general revenues to fund Social Security benefits for the next 47 years.

When the Trust Fund Is No More

But what happens when the trust fund is indeed exhausted? In terms of today's elder law clients, and many of tomorrow's as well, a flip answer would be: "Who cares?" The more serious answer, however, is that Social Security receipts would continue to come in and even with no balance in the "trust fund," the program could pay at least 81 percent of currently provided benefits, as far as the eye can see. Note that this estimate does *not* mean that Social Security benefits would necessarily be cut by 19 percent. Nor does it mean that Social Security's payroll tax must inevitably be increased to fill the shortfall. It simply means that the revenue stream that is associated with Social Security would be 19 percent less than the program's projected benefits, requiring an allocation of funds from other uses of existing government resources.

Filling the Projected Shortfall

The above scenario is hardly catastrophic, much less a description of a "crisis" or a program that is "flat broke" or "bankrupt," as President Bush and Vice President Richard Cheney have frequently claimed. But it does present a dilemma for the long-term, with an emphasis on *long*-term. If one does want to address this anticipated shortfall now, what alternatives exist that might substantially ameliorate, or even eliminate, this situation?

The first such approach would be to use more realistic estimates of future economic growth. The CBO projections cited above assume that the US economy will grow at an average annual rate of only 1.2 percent after inflation, even though the average annual growth rate since 1930 is 3.2 percent. Using a figure of 2.6 percent wipes out the Social Security deficit beyond the next *century*.

A different approach would reallocate government funds to support the Social Security program. Such reallocations happen all the time. The anticipated shortfall could be completely fixed by increasing the allocation to Social Security over 40 years in an amount no greater than was reallocated to defense spending from 1979 to 1986. Whether this reallocation is desirable is a different issue entirely, but the point is that this country has made comparable reallocations over a much shorter period, and within recent memory at that. As a friend of mine says, "This isn't rocket surgery."

Still another approach would alter the calculation of the Consumer Price Index (CPI) to make it more realistic. The present formula takes no account of how real consumers react to price hikes in basic commodities, and it should do so. This solution is really deep into the realm of statistical "nerddom," but it alone would take care of a portion of the projected Social Security shortfall.

The administration has proposed a similar approach with very different consequences, namely, change the methodology by which initial Social Security payments are calculated. Their plan would substitute the CPI for the current formula that indexes prior earnings by a measure of wage growth. It all sounds terribly technocratic, but this technique fixes the problem of Social Security's shortfall completely, according to the administration's own analysis. It does so, to be sure, by lowering Social Security benefits *not for any current retirees* but only for workers who join the system after some as-yet unspecified date. While AARP and other advocacy groups have assailed this proposal vociferously, the fact is that the current wage-based formula was not part of Social Security until 1977, and a strong case can be made that a CPI-indexed benefit formula better accords with most workers' expectations of how retirement benefits are calculated.

One other approach would simply be to raise taxes. Never a popular strategy, this approach would nevertheless take care of the projected shortfall. How much would taxes need to be raised? One estimate shows that returning to the income tax schedule that existed before President Bush's 2001 tax cuts would do the trick, even if this rollback were applied *only to the top 1 percent of US taxpayers*, essentially those with taxable income in excess of $350,000 per year. A different alternative would be to lift the annual cap on Social Security's payroll tax and apply it to the same base as Medicare's payroll tax. Even as prominent a taxophobe as President Bush has indicated that he is "open" to this possibility, which would affect only one in 16 Americans who have income from wages, salaries, or self-employment.

Without pretending to exhaust the possibilities, one final suggestion would be to raise the age of full retirement. As noted above, this approach was actually adopted in 1983 and is currently in the process of being implemented. The current phase-in schedule could be accelerated or a new, higher age could be adopted. When Social Security was first adopted, the average life expectancy of Americans was 61.5 years. Now, it is closer to 77 years. Restoring the program to its original parameters, therefore, would imply a full retirement age of 81.4 years. While no one, or at least no politician who expects to ever face the voters, is suggesting such an increase, raising the full retirement age to 75 years would eliminate almost all of the Social Security program's projected shortfall. The fact remains that this program was designed to provide financial support for older people when they can no longer support themselves, not to finance two or more decades of enforced idleness.

Web Link Update

Our January issue provided a now-outdated link to the full text of *Estate of DeMartino v. Division of Medicare Assistance and Health Services* (N.J. Super. Ct. App. Div., No. A-2807-02T2, Nov. 10, 2004). A current link is *http://lawlibrary.rutgers.edu/courts/appellate/a2807-02.opn.html*.

In any case, the main point is that there are a variety of approaches, any one of which would significantly reduce, if not completely eliminate, Social Security's projected shortfall. Moreover, many of these approaches can be adopted piecemeal or in combination with one another to yield the same result with less dislocation than any single approach would engender on its own.

Individual Accounts

Many particulars of the President's proposal have not yet been released and may be some time in coming. Moreover, even when these provisions are made public, what emerges from the legislative process may look very different from what the President proposes. The recent enactment of Medicare's prescription drug benefit is an apt example of what happens when Congress works its way. Nevertheless, certain concepts have been discussed with enough specificity to suggest some preliminary analyses.

For example, President Bush envisions that individual accounts in Social Security would be available only to persons who are not yet 55 years old when the new program takes effect. Thus, clients who are currently receiving Social Security retirement benefits have no direct stake in President Bush's proposals, and neither do prospective retirees if they are at least 55 years old. The President's plan, in other words, is geared almost entirely to younger workers.

Clothing Gifts No Longer Count As Income Under New SSI Rules

The Social Security Administration (SSA) will no longer count gifts of clothing as part of income or household goods as resources in deciding whether a person can qualify for Supplemental Security Income (SSI) benefits under final rules just issued. 70 *Federal Register* 6340-6345 (7 Feb. 2005).

First, the agency is eliminating clothing gifts from the definition of income and from the definition of in-kind support and maintenance. As a result, it says it generally will not count gifts of clothing as income when deciding whether a person can receive SSI benefits or when it computes the amount of the benefits.

Second, SSA is eliminating the dollar value limit (previously $2,000) for the exclusion of household goods and personal effects. As a result, the agency will not count household goods and personal effects as resources in deciding whether a person can receive SSI benefits.

Third, the SSA is changing its rules for excluding an automobile in determining the resources of an SSI applicant or recipient. It will exclude one automobile (the "first" automobile) from resources if the vehicle is used for transportation for the individual or a member of the individual's household, without consideration of its value.

The regulations took effect March 9, 2005.

As to those workers, the President's proposal permits, but does not require, employees to divert 4 percent of their wages into individualized Social Security accounts, with an initial cap on annual contributions of $1,000. In other words, only the first $25,000 of annual wages would be available for establishing personal accounts, and none of the employer's portion would be touched for this purpose. Whatever the ideological merits of this proposal may be, these diversions will only exacerbate Social Security's funding problem, because the funds put into these personal accounts will not be available to meet the program's ongoing obligations. No less a fan of personal accounts than Federal Reserve Board Chairman Alan Greenspan testified before Congress in mid-February that individual Social Security accounts do *not* address Social Security's projected shortfall. Indeed, that is why the administration anticipates "transition costs" of anywhere from $750 billion to $2 trillion to implement these accounts. The actual number may be even higher, but the main point is that individual accounts make Social Security's long-term situation worse, not better.

Individual accounts raise a number of significant practical issues, from the administrative hassles involved in handling very small accounts to the nature of investment options and restrictions on changing selections. Questions about payouts are even more perplexing. For example, will workers have access to these accounts prior to their retirement? The President's proposal says "no," but if these accounts truly belong to the workers and represent money that "the government cannot take away," in the words of President Bush, can pre-retirement access really be restricted? The President's proposal also provides that, at retirement, a worker would be required to annuitize some significant portion (perhaps all) of his or her account, in which case that portion of the account would *not* be available to be "passed on to loved ones," again quoting President Bush.

Whether younger workers should opt for these individual accounts is impossible to determine at this point, in part because so many key elements of how these accounts would operate are still unknown. For example, people who choose such accounts will receive smaller guaranteed benefits under Social Security, but how much smaller? This question highlights the critical point that individual accounts are actually *substitutes* for, rather than simple additions to, current Social Security retirement benefits. Even more speculative is the impact of this radical transformation of the Social Security program on US financial markets, especially the stock market. Indeed, some estimates of anticipated stock market growth are so high that the underlying economy would necessarily be growing at a rate that would keep Social Security solvent *forever*! The bottom line is that no one can be certain whether individual accounts will help or hurt the younger workers at whom this proposal is aimed.

The IRA Alternative

In any case, clients who like the idea of individual accounts for funding one's retirement might want to consider an alternative that already exists, namely, the Individual Retirement Account (IRA). In many key respects, the IRA is more appealing than what President Bush has proposed for Social Security:

- Eligibility for an IRA is not restricted by age (vs. must be under 55 years old).
- The maximum annual contribution for an IRA is $4,000, or $4,500 for persons who are at least 50 years old (vs. $1,000 initially, rising by $100 per year after 2009).
- An IRA can be invested with almost any financial institution (vs. a handful of selected investment firms).
- An IRA can be invested in a wide range of investments, from bank certificates of deposit to individual stocks to US gold and silver coins (vs. a few "very conservative" funds that track broad asset classes).
- An IRA can be preserved largely intact, other than "minimum required distributions," to fund inheritances (vs. mandatory annuitization for part or even all of the account, depending upon its size).
- An IRA can be funded on whatever schedule best suits the account holder, even single payments made *after* a year has ended (vs. mandatory contributions out of each and every paycheck).

Finally, an IRA can be funded with pre-tax money in many cases, depending upon a person's income and present participation in an employer-provided pension plan. In contrast, President Bush's Social Security accounts would come from after-tax money; that is, those funds would be subject to federal and state income taxes, as is the case now for Social Security withholdings. Clearly, the traditional IRA is a better ticket to the "ownership society."

Conclusion

Social Security is not in economic peril and can pay benefits as long as the program has political support. Numerous options exist to fill any anticipated shortfall from its dedicated payroll tax with minor, or in some cases inconsequential, changes. In any case, President Bush's proposal for individual accounts would only exacerbate Social Security's financing difficulties. Finally, even those who are attracted to the personal control and "ownership" aspects of President Bush's proposed individual accounts have a more appealing alternative already available: the traditional Individual Retirement Account.

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