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The Benefits of a Fully Funded Social Security System

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Abstract
Congress has discussed several reform proposals [for the Social Security system], but has failed to agree on a solution that maintains the redistributive structure of the current system while also providing economic advantages. This paper consists of several additional sections that logically demonstrate why a fully funded system with the buildup of a large permanent trust fund is the most advantageous Social Security reform proposal.

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By Nathan Taulbee

I. INTRODUCTION

The Social Security system, formally known as Old-Age and Survivors Insurance Disability Insurance (OASDI), began in 1935 under the direction of former President Franklin Roosevelt. The original purpose of the system was to ensure that the nation's elderly could earn a decent income in the later years of their life. At that time, the elderly experienced horrific financial turmoil as numerous banks failed due to the Great Depression and the stock market crash of 1929. The implementation of the Social Security system pleased many Americans in the 1930's, and has continued to persevere throughout the latter portion of the twentieth century. However, recent data indicate that funding for the system will be exhausted in 2029 (Sass, 1997). Congress has discussed several reform proposals, but has failed to agree on a solution that maintains the redistributive structure of the current system while also providing economic advantages. This paper consists of several additional sections that logically demonstrate why a fully funded system with the buildup of a large permanent trust fund is the most advantageous Social Security reform proposal. In Section II, the specific reasons why the system is financially unsound today will be discussed. Section III will examine research on the major reform proposals. Section IV will explain what a fully funded system is. Sections V and VII will explain how a fully funded system can be achieved. Section VI will examine the advantages and disadvantages of a fully funded system in comparison to other reform proposals. Empirical analysis will assist in supporting this claim. Finally, the last section will offer some concluding thoughts on the macroeconomic effects of reforming the Social Security system.

II. WHY THE SYSTEM IS FINANCIALLY UNSOUND TODAY

The original intent of the Social Security system was that a fully funded system financed by the payroll tax would be used as a government transfer program to assist the elderly poor. Since that time, however, several changes have been made. For example, in 1939 the U.S. government replaced the fully funded system with a pay-as-you-go system in order to meet the needs of current retirees. Under a pay-as-you-go system, payroll tax revenues from current workers are used for the payments to current recipients. The problem with the pay-as-you-go system is that the projected support-benefit ratio will not be adequate to continue Social Security far into the 21st century. According to the Cato Institute, only 2 workers will support a beneficiary in 2025, as opposed to the 16 workers that supported each beneficiary in 1950 (Shipman, 1995). The primary cause of this is that the abundant Baby Boom generation will soon reach retirement, causing a dramatic increase in the needed revenues to pay for retirees. In addition, the birthrate has declined tremendously since the mid-1900's from at least 2.5 children per woman to less than 2 children per woman. According to the Social Security Administration, this trend is expected to continue into the 21st century (Beach, 1998). Finally, Americans are living much longer due to medical advances, causing the support-benefit ratio to decline even more. Table 1 illustrates the rising trend of additional years lived beyond retirement. (Beach, 1998)

With the decline in the support-benefit ratio, payroll tax revenues will eventually no longer meet the benefit outlays. When this occurs, the government will then use money from the Social Security Trust Fund to pay for the deficit. In essence, the trust fund serves as a safety net in times of Social Security deficits. Beginning in 2012, revenues from current workers will not cover the payments to current retirees, which means that the government must delve into the trust fund. According to data from the Social Security Administration, the current trust fund will be exhausted in 2029, as deficits are projected to continue well after 2012 (Sass, 1997). As a result of this, many workers that paid into the system would not receive the benefits they expected in retirement. In order to continue a successful Social Security program that maintains a redistribution element, reform is needed today.

Table1: Average Life Expectancy for those reaching age 65

Year	Years of Life After 65
1935	12.6
1998	17
2040	19

III. A REVIEW OF MAJOR REFORM PROPOSALS

Three major reform proposals that currently exist today are the Maintain Benefits proposal, the Individual Accounts proposal, and the Personal Savings Accounts proposal. Much research currently exists on these proposals with clear ideological beliefs impacting the findings. For example, research from the Brookings Institution, a rather liberal organization, supports the Maintain Benefits proposal while research from the Cato Institute, a libertarian organization, favors the privatization proposals.

The chief characteristics of the Maintain Benefits proposal is that the current defined benefit structure of Social Security will be maintained with slight alterations being made to the size of the trust fund. Under a defined benefit Social Security system, a benefit formula based on an individual's average career earnings along with his or her age determines the amount received in retirement. The intent of this benefit formula is to redistribute income to those with lower average career earnings. The redistributive component of the current system is the primary reason why members of the Brookings Institution favor the Maintain Benefits proposal.

The main proposal for altering the current system while maintaining its defined-benefit structure is the one that implements a fully funded system with the buildup of a large trust fund. This reform proposal offers great economic advantages that the privatization proposals do not offer. A greater examination of this proposal along with its advantage will be discussed in the next three sections.

Meanwhile, the two major privatization proposals, the Individual Accounts proposal and the Personal Savings Accounts proposal, are based on a defined contribution element in addition to the defined benefit element. That is, retirees receive a general amount of funding determined by the current benefit formula along with a specific amount of funding that is determined by the success of that retiree's contribution account. For example, under the Individual Accounts proposal, a new 1.6 percent employee payroll tax would be used as a source of revenue for each individual's own account. The current 12.4% payroll tax that is split between employers and employees would not change under this proposal (Beach, 1998).

Under the Personal Savings Accounts proposal, 5 percent out of the total 12.4% payroll tax would go toward a privately managed personal account. The remaining 7.4 percent of the payroll tax would be used as a "flat retirement" benefit for recipients. The primary difference between the Personal Savings Account proposal and the Individual Accounts proposal is that individuals manage the investment of funds in the former account while the government manages funds in the latter account (Beach, 1998).

Because the Individual Accounts proposal and the Personal Savings Accounts proposal both favor a defined contribution component to Social Security, less revenue would be available for redistribution to the elderly poor. The Cato Institute favors these privatization proposals primarily because of the individual choice that they would offer (Shipman, 1995). Though many people favor privatization and believe it is the answer to the current Social Security crisis, having a fully funded system with a large trust fund is the most advantageous proposal. The remainder of the paper will examine the characteristics and advantages of a fully funded system along with the disadvantages of a privatized system.

IV. WHAT EXACTLY IS A FULLY FUNDED SYSTEM?

As stated previously, the Social Security system currently operates under a partially funded system. That is, payroll tax revenues from current workers are used for current retirees. And in years of a Social Security deficit, the trust fund will be used as the additional source of revenue needed to pay benefits to retirees. Under a fully funded system, all benefits paid out to recipients come directly from the revenue in the trust fund. When a large enough trust fund is achieved, current workers will no longer have to support current retirees. But what exactly determines whether the trust fund is large enough to be deemed "permanent?" According to the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, "The long-range [permanent] estimates include the cost of ending the seventy-five year projection period with a trust fund equal to 100% of the following year's expenditures." (Diamond, 1997) In addition, the Board of Trustees made the following conclusions about a large permanent trust fund:

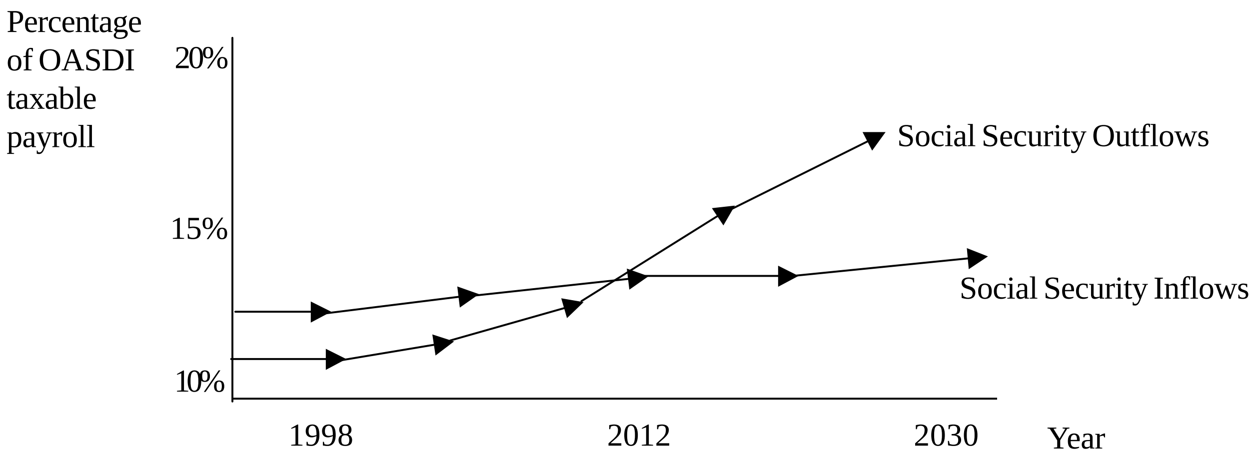
"If the estimated trust fund ratio for a fund is at least 100 percent at the beginning of the projection period, then it must be projected to remain at or above 100 percent throughout the 10-year projection period. Alternatively, if the ratio is initially less than 100 percent, then it must be projected to reach a level of at least 100 percent by the beginning of the sixth year and to remain at or above 100 percent throughout the remainder of the 10-year period. Failure to meet this test … is an indication that solvency of the program over the next 10 years is in question and that Congressional action is needed to improve the short-range financial adequacy of the program." (Diamond, 1997)

It may not seem like much of a problem to achieve this defined permanent trust. However, moving from the current partially funded system to a fully funded system requires in-depth analysis.

V. HOW TO ACHIEVE A FULLY FUNDED SYSTEM

In order to obtain a fully funded system,

Figure 1: Social Security Inflows versus Outflows



Congress first must eliminate the projected 2012 Social Security deficit (Beach, 1995). Figure 1, a graph from the 1995 Bipartisan Commission on Entitlement and Tax Reform, illustrates the rise in Social Security outflows relative to inflows over a 37-year period, with the breakeven point occurring at the projected 2012 date (Shipman, 1995).

To eliminate the projected 2012 deficit, several modifications must be made to the current system. One such modification requires increasing the working period over which a retiree's benefits are computed. It is estimated that the projected Social Security deficit will be reduced by 12% if benefits are computed over a period of 38 years rather than 35 years. This is because each recipient's payment will be lower due to the three additional lower income years (Overview, 1998).

In addition to adding lower-wage years to the benefit computation, the Social Security deficit can also be reduced if government workers are added to the system. Expanding coverage to the 3.7 million state and local government employees would reduce the projected Social Security deficit by 10% (Overview, 1998).

A third modification that would reduce the Social Security deficit is an acceleration of the future retirement age to 67. Currently, those individuals age 65 and older are considered retirees (though early and late retirement is possible). The Social Security Act of 1983 called for an increase in the retirement age to 67 by 2022. By increasing the retirement age to 67 in 2011 rather than 2022, 22% of the projected Social Security budget deficit can be reduced (Overview, 1998).

A fourth way of reducing the projected deficit is by reducing the Consumer Price Index (CPI) by .21 percent each year. Many economists believe that the CPI can be reduced even further because it currently overstates inflation tremendously. The effect of a .21 percent adjustment to the CPI would reduce the projected Social Security deficit by 14% (Overview, 1998).

A final way of reducing the 2012 Social Security deficit is through taxation of any additional benefits a retiree receives beyond what he or she contributed. Implementing this policy would reduce the deficit by 14% also (Overview, 1998). These five measures put together would reduce the projected Social Security deficit by an estimated 72%.

Once the projected Social Security deficit is eliminated, Congress must find a way to add to the current trust fund in order to build up a large permanent trust fund. One such way to accomplish this is through a payroll tax increase. According to actuarial data from the Social Security Administration, a permanent 2.23 percent increase in the payroll tax would restore financial balance over the next 75 years (Diamond, 1997). However, this raises questions of equity, since the payroll tax is a flat rate as opposed to a progressive rate. Perhaps a more equitable solution is to build up the trust fund with increased income taxation. By taxing income over payroll, higher income individuals will pay more into the large trust fund. Implementing a progressive structure into the buildup of the large trust fund is necessary to maintain the redistributive component of Social Security.

Finally, with the recent budget surpluses and the predicted future surpluses, Congress should consider allocating portions of these surpluses to the Social Security Trust Fund. By doing this, the government can build up the trust fund without raising income tax rates as much. In conclusion, by implementing any combination of these modifications to the current Social Security system, Congress can make steps toward eliminating the projected 2012 Social Security deficit and building a permanent trust fund.

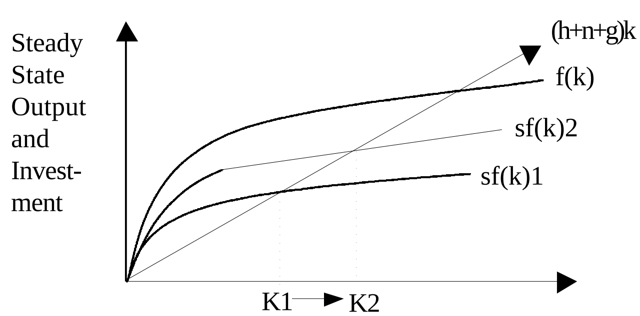
VI. THE ADVANTAGES OF A FULLY FUNDED SYSTEM

A fully funded Social Security system would be very beneficial for several reasons. One reason is that when full funds are obtained, the system will have fewer worries over future near-term projected deficits. The government would then be able to concentrate on more demanding issues.

A similar advantage of a fully funded system is that it maintains much of the structure of the current system. Many Americans will likely be pleased to maintain the current system that has proven to be popular in its years of existence. Because of this, members of Congress will be able to focus on other, more pressing issues on Capital Hill in Washington, D.C.

In addition to political reasons, a fully funded system would also give the government more opportunities to invest a portion of the funds in equities. Numerous studies indicate that investing a portion of the trust fund into equities would increase the rate of return tremendously. For example, according to the Advisory Council of Social Security, if the U.S. began to build a permanent trust fund with government securities in 1997, that trust fund would hold approximately $1 trillion. If 40% of the trust fund in 1997 were invested in equities, that same trust fund would hold $60 trillion (Diamond, 1997). Though investing a portion of the trust fund into equities provides a much greater return, it is important to note that a much greater amount of risk is involved. In addition, the government would have partial ownership of many American companies, which has many political drawbacks. Although some disadvantages do exist with private investment of the Social Security Trust Fund, the main advantage of having a large trust fund as opposed to the current trust fund in regard to equity investments is that the government has more room for error.

Figure 2: The Effect of Increased Social Security on Capital Stock per Worker



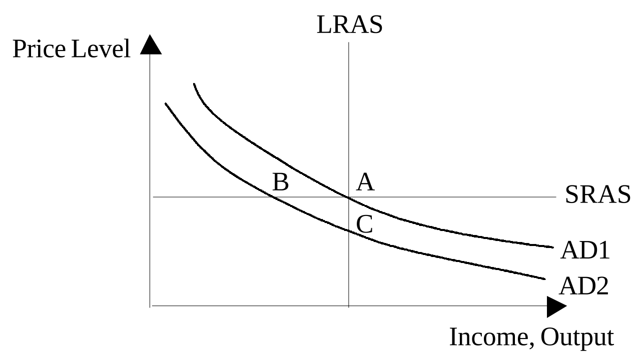
The chief economic advantage of preserving Social Security with a fully funded system is that national saving (public saving minus private saving) will increase, thus inducing future growth in the economy. According to Steven Sass and Robert Triest, two participants in the 41st annual economic conference of the Federal Reserve Bank of Boston in June, 1997, increasing funding of Social Security will "restore Social Security's fiscal solvency" and "increase national saving and future living standards." (Sass, 1997) The Solow growth model, a macroeconomic model that links savings to economic growth, is the necessary tool to demonstrate how building up the trust fund will increase future living standards. According to Figure 2, as savings increases, sf(k)1, the current saving rate in the economy, shifts to sf(k)2, the new saving rate in the economy, and a new equilibrium amount of capital per worker (k2) in achieved. And according to Macroeconomic theory, as the original capital per worker level k1 rises to k2, additional gross domestic product (GDP) can be produced, resulting in economic growth. One important outcome of the 41st annual economic conference of the Federal Reserve Bank of Boston is that privatization does not have the same impact on national saving that the buildup of a large permanent trust fund would have. According to Triest, "Privatization of Social Security might be a politically feasible means of achieving increased pre-funding, but by itself would not necessarily increase [national] saving." (Sass, 1997)

Another advantage of a fully funded system that privatization proposals do not have is its redistributive makeup. Since Social Security was established as a transfer program to assist the poor elderly, a fully funded system does not change the redistributive structure of the current system. Although the size of the Social Security funds may change with a permanent trust fund, nothing is done to the allocation of these funds. Thus the defined benefit structure of the current system is maintained. On the contrary, various privatization proposals eliminate part or all of the defined benefit structure in favor of a defined contribution structure, making Social Security less redistributive. The reason for this is that a certain percentage of individual's payroll tax revenues would be placed in a private account that could only be utilized by that individual. The primary problem with this is that less money is available for redistribution, making Social Security more of a complete pension program rather than a transfer program. It is essential to remember that Social Security is a government transfer program aimed at helping the elderly poor.

VII. THE DISADVANTAGES OF A FULLY FUNDED SYSTEM

Though a fully funded system has many advantages, some drawbacks are present. For example, increasing saving to build up the larger trust for higher future consumption results in less consumption today. Figure 3 demonstrates how GDP will fall in the short run due to a downward shift in the aggregate demand curve (AD1 to AD2) because of the decreased consumption levels of both retirees and employees. As aggregate demand drops, the equilibrium amount of output falls from Point A to Point B. In the long run, the economy will move to Point C, the full employment level of output (located on the long-run aggregate supply curve). Although the decline in output today (the move from Point A to Point B) results in economic hardship for Americans, this hardship can be justified by the fact that the nation's pool of saving and capital stock would be reduced in the future anyway [if no changes were made to the current system] because of the necessary sale of trust fund assets expected in 2019 (Sass, 8). Thus the question becomes one of sacrificing now for the continuation of social security in the 21st century versus sacrificing at a future time that results in no continuation of social security.

Figure 3: Short-Run Impact of an Increased Trust Fund



A second drawback of moving toward a fully funded system is that one generation must pay for itself and for the current retirees. While the permanent trust fund will be sufficient for future retirees, current retirees must somehow continue to receive payments during the transition period. Perhaps the most equitable solution to this transition period problem is to spread the burden over everyone. This can be accomplished by reducing benefits of current retirees while raising the payroll tax rate beyond what is needed to help build up the permanent trust fund.

VIII. CONCLUSION

Reforming Social Security is not an easy task. Although moving toward a defined-benefit fully funded system with a permanent trust has many advantages, critics still claim that it is not the right solution. Some opponents argue that the transition costs to a fully funded system would require some generations to "pay twice." However, any reform proposal would result in one generation paying more than "its fair share." According to data found by The Century Foundation, in addition to requiring the current generation of workers to "pay twice," privatization of Social Security would also require about $6.5 trillion in additional taxes over the next 72 years. Other opponents claim that selecting a permanent trust fund over privatization lowers the rate of return for retirees. Though this may be true if a portion of the large trust fund is not invested in equities, how can anyone be sure that the stock market will remain a safe investment source in the future? When factoring in the additional taxation of privatization, the insecurity of private individual accounts, and the fact that nearly every reform proposal requires one generation to pay more than its fair share, proponents of privatization are left with little to argue. Meanwhile, advocates of a fully funded system with a permanent trust fund can claim that increased national saving will spur future economic growth and that, most importantly, the progressiveness of the current system can be maintained.

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