The Only Real Solution to the Social Security Problem

Alan C. Stockman

Wilson Professor of Economics

University of Rochester

716-275-7214

http://www.stockman.net

alan@stockman.net

Prepared for the Shadow Open Market Committee Meeting

October 16, 2001.

The Only Real Solution to the Social Security Problem

Alan C. Stockman
Wilson Professor of Economics
University of Rochester

Social Security is the largest single program in the U.S. federal government budget, accounting for about 23 percent of all federal spending. Taxes to finance Social Security add substantially to overall marginal tax rates on the incomes earned by most Americans, and many pay more Social Security taxes than federal income taxes. Consequently, issues associated with Social Security, including its effects on employment and economic growth, the implicit rate of return it provides on saving for retirement, and its effects on the distribution of income across generations, genders, races, and income classes, have generated substantial public debate. One particular issue stands out, however: under current law, the system will require the federal government either to raise taxes, reduce benefits, cut other spending programs, or raise the federal debt starting in about 2016. The system's fiscal problems led to the creation of the President's Commission to Strengthen Social Security. That commission's ongoing work was delayed by the terrorist attacks of September 11.

Despite the large quantity of public debate and discussion on Social Security, its problems, and potential reforms, most of that discussion obscures the key problem with minor points, irrelevancies, and politically-motivated rhetoric. The key problem is simple: Demographic changes in the United States, associated with retirement of the baby-boom generation, will create a problem for the Social Security system in the coming decades. More people will be retired, collecting Social Security benefits, and the United States will have fewer workers per recipient.

Sometimes this fact is stated slightly differently: The ratio of the number of people receiving Social Security payments will increase relative to the number of workers paying into the system. While true, this way of stating the problem creates potential for obscuring the key issue. That issue is *not* how many people are paying into the system relative to the number of recipients. (If that were the problem, then any solution would require adding more workers or reducing the number of recipients.) The real problem is that a decline in

the labor force relative to the population could entail a decline (or shortfall relative to past growth trends) in *per capita* production, and consumption, of goods and services.

To fix ideas, focus on the year 2030. Most of the baby-boom generation will be retired, so the United States will have a larger number of senior citizens. Unless those seniors live on incomes substantially below the average level of seniors today, this implies:

In 2030, seniors will consume a larger quantity of goods and services.

The key question is:

"*Where will these goods and services come from?*

The possible answers are limited. The goods and services that seniors consume in 2030 could come from:

(1) Lower consumption by other people (younger generations) in 2030.
(2) Lower national investment in 2030 (reduced creation of new tools, machinery, etc.)
(3) Other countries. (The United States could *borrow* those goods and services by running a large trade deficit.)
(4) An increase in GDP in 2030 resulting from a rise in the number of seniors who continue to work into their seventies or eighties.
(5) An increase in GDP in 2030 resulting from an increase in the capital stock -- the technologies, tools, machines, human skills, and other productive inputs available to the economy -- in 2030.

Obviously, if the United States waits until 2030 to solve the problem, only options (1)-(4) will be available.

The key policy question *today* (in 2001) is: What can the United States do *now* – prior to 2030 – to alleviate the problem? The answer is clear: there is only one reasonable solution: *take actions* <u>*now*</u> *to raise GDP in 2030* by raising the economy's expected productive capacity in that year. In summary:

No changes in the system – no financial changes, legal changes, tax changes, regulatory changes, or other policies – can address the main problem of Social Security unless they raise the economy's long-run rate of economic growth.

Consider the alternatives. A reduction in consumption by younger generations in 2030 hardly constitutes a "solution" to the problem. The problem, after all, involves providing

for the retired baby-boom generation without placing such a burden on future generations. For the same reason, option (3) -- borrowing from foreign countries to provide goods and services for retired baby-boomers -- simply shifts the cost onto later generations, who would pay interest and principal on larger international debts. So these options fail the basic test of "solving" the problem. Nor do these options address the question of what policy actions *today* can help to solve the impending problem. These options, instead, call for policies in 2030 to impose high taxes on younger (working) generations or to borrow from the rest of the world.

The same objections apply to option (2). The United States could, in 2030, devote fewer resources to maintain and create new machinery and equipment, to finance research and development, education and training, structures and infrastructure. We could divert those resources to produce health care, entertainment, housing, and other products and services for retired baby-boomers. But this option hardly constitutes a solution to the problem, as it reduces the economy's productive capacity in subsequent decades, merely shifting the burden to subsequent generations.

Nor does option (4) – later retirement and increased labor-force participation by seniors – constitute a true solution to the problem. Instead, it provides a glimpse into a crystal ball, showing the probable future for many baby-boomers if the United States *fails* to address soon the underlying problem of Social Security.

The only real solution to that key underlying problem is economic growth. Our actions today will affect the economy's capital stock in 2030. An increase in the capital stock – broadly conceived to include technology, knowledge, and human skills – will raise the economy's productive capacity and allow us to provide goods and services for a larger generation of retired persons, without reducing the consumption of younger workers below the level that it would have been absent that demographic shift.

No economic projections for coming decades can pretend to have much accuracy, but a ballpark calculation can show roughly how much growth is required. (This answer ignores many relevant issues such as changes in the composition of the labor force and associated changes in wages, changes in family sizes, etc.) Suppose that the ratio of workers to retirees falls from its current level of 3.4 to 2.0 in 2030. (Most predictions place the ratio at about 2.3 in 2025 and about 2.0 in 2050; however, today's ratio, 3.4,

already lies well below the 1960 ratio of greater than 5.) If per-capita consumption were the same at every age, then the output of 3.4 workers today would provide goods and services for 4.4 people (the 3.4 workers plus one retiree), while in 2030 the output of 2 workers would provide the goods and services for 3 people. In other words, the output of 2.93 workers (which equals 2/3 of 4.4) would provide for every 4.4 people. To provide the same level of goods and services per person, 2.93 workers in 2030 must produce the same quantity of goods and services that 3.4 workers produce today. That means output per worker must grow by (3.4/2.93)-1 or about 16% between now and 2030. That is, roughly, the increase in output per worker necessary to sustain the *same* living standards as today. If U.S. per-capita real GDP grows at its twentieth-century rate of about 1.8 percent per year, then it will increase by about 65 percent between now and 2030. The required 16-percent increase takes 8 to 9 years at this historical growth rate. In other words, achieving the historical level of growth plus an *additional* 16 percent growth by 2030 to compensate for the decline in workers per capita would require 81 percent growth over the next 28 years, or an annual growth rate of about 2.1 to 2.2 percent. To summarize: to compensate for the baby-boom-induced decline in workers per person without falling below the growth rate of the last century requires raising the annual growth rate of GDP per worker from its twentieth-century rate of about 1.8% to a higher rate of about 2.2.% per year for the next several decades.

The United States should adopt a variety of changes in economic policy to help promote additional long-run growth. Because many current policies *hinder* growth, the United States would benefit by changing these policies, thereby reducing economic inefficiencies, even in the absence of the demographically-induced Social Security problem.

First, the United States should adopt policies to shift taxes from income to consumption. While all taxes create economic inefficiencies, the government should attempt to raise the revenue it requires to finance its spending through a system of taxes that minimizes those inefficiencies. Taxes on saving create much larger inefficiencies than taxes on consumption. Income taxes combine taxes on consumption and saving, because people pay those taxes regardless of whether they spend or save their income. The U.S. tax system not only taxes savings, it taxes savings at particularly high rates because the

same income is often subject to both corporate and personal taxes. While the ideal tax system would impose taxes only on consumption, and the United States should attempt to move toward such a system, a smaller series of policy steps – likely to be more feasible politically – would move us in that direction. Those steps include expansion of all programs that reduce or (ideally) eliminate taxes on interest income and other forms of investment income, or that allow people to defer income taxes on money that they save.

Second, the United States should reduce marginal tax rates on all sources of income. (Note that this does not require reducing average tax rates: whether average tax rates should be changed is largely a separate issue.)

Third, the United States should reduce substantially the burden of regulations on business. Regulations, like taxes, are probably a substantial drag on economic growth. The government should subject all existing regulations to cost-benefit analyses on a regular basis and should change or eliminate those regulations that fail the cost-benefit test. That cost-benefit analysis should include an analysis of the regulation's likely impact on economic growth. Note that this prescription does not limit the ability of the government to impose new regulations where benefits exceed costs; some new regulations designed to deal with terrorist threats may easily pass a cost-benefit analysis.

Fourth, the United States should reform the legal system to reduce the burden of litigation on businesses. Reforms should aim simultaneously to reduce the quantity of lawsuits and their costs, and to speed their resolution. The burden of litigation acts as an implicit tax on investment, entrepreneurship, and innovation. Reforms could contribute to economic growth.

Policies that enhance long-run economic growth would help to solve the key demographic problem that Social Security faces. Paradoxically, however, the Social Security system *itself* contributes to the problem. When the baby-boom generation retires, their incomes will come from their accumulated savings and through transfer payments from younger generations (both through Social Security and other programs). The political system in 2030 will decide on some level of transfers. The record-high fraction of seniors in the overall population is likely to affect the outcome of that political process. If baby-boomers expected *no* transfers – no Social Security benefits – from younger generations in 2030, then they would be forced to make provisions for their own retirements by saving.

Current policies not only tax saving (at high levels) but discourage saving by promising Social Security benefits that substitute for personal savings. Consequently, the existence of the Social Security system reduces private savings. Without offsetting saving by the government (which has not occurred in the past and is unlikely to occur in the future), this reduces the nation's capital stock. In this way, the Social Security system has already reduced the economy's productive capacity and wealth, and the incomes of average Americans.

Retired baby-boomers in 2030 will live partly off transfers from younger generations. The only way to prevent the demographically-induce increase in transfers from reducing consumption of younger generations is to raise their pre-tax wages, so that the (larger) Social Security tax burden does not reduce their real after-tax wages. Higher wages can come only from higher productivity. And that higher productivity can come only from increased investments – now, *before* 2030 – in new capital (again, broadly interpreted to include development of new technologies).

Many proposed reforms for Social Security fail the basic test. They contribute nothing to the long-run economic growth that resolution of the problem requires. A lockbox for Social Security revenue can help solve the Social Security problem only if it raises current savings and investment. If a lockbox for that revenue reduces government spending, it might raise savings and investment. But if a lockbox merely raises taxes, it is unlikely to raise national savings and investment. In other words, the size of the Social Security trust fund is irrelevant, except to the extent that it affects savings, investment, and long-run growth. But a larger trust fund may lead to people to place greater *trust* in the Social Security to provide for their retirement, and reduce the extent to which they save to provide for their own retirement.

The Interim report of the President's Commission to Strengthen Social Security claims, misleadingly, that economic growth is *not* a solution to the problem. They say, correctly, that retiree benefits are currently indexed to wages. Of course, increased economic growth would permit changing that indexing formula without reducing payments to retirees. The Commission errs in viewing Social Security's problem solely as a problem of the government's budget, rather than as a problem of moving to an economy with a smaller fraction of the population in the labor force.

Another misleading claim is that the Social Security problem will begin around 2016, when the system will become insolvent in the sense that its annual cash payment obligations will exceed its revenues from taxes." It is true that around 2016 the system will require additional revenue from the government to meet its currently-legislated outlays, and that this revenue will have to come from higher taxes, increased government borrowing (higher budget deficits), or reductions in other government spending. However, this event refers only the effect of the Social Security system on the *government's budget.* From a broader perspective, the problem will begin slowly *before* 2016 and increase over time as more baby-boomers leave the work force and begin collecting Social Security benefits. The problem of Social Security, to repeat, is there will be a larger number of senior citizens consuming goods and services but not producing them. Of course, changes in the *government budget* will have to occur at (or before) that time, but changes in *family budgets* – which reflect the reality of the economy's available goods and services – will already have been in progress as the worker/retiree ratio declines with each passing year.

For the same reason, it is misleading to claim as a particular crisis year the later date (perhaps 2038) at which the Social Security system becomes insolvent in the sense that the trust fund balance falls to zero. When that happens, it will be a notable event for accountants and lawyers, but not for the economy. Our political system will already have developed a set of taxes and transfers that reflect the political forces of the time.

The United States can address honestly and squarely the problem of Social Security only if it faces the underlying issue. Any proposal to address the Social Security problem should be evaluated by its likely contribution to long-run economic growth. That does not prevent honest consideration of issues, including how the Social Security system, and proposed reforms, affect the distribution of income and individual freedom of choice.