CURRENT EVENTS

It has been said that the U.S. Social Security system is facing imminent crisis and requires immediate reform.

Many readers may be surprised to know:

- **Terms like "bankruptcy" and "insolvency" exaggerate the problems.**
  - **The Social Security trust funds are not now in trouble.**
  - **A 1.5-trillion-dollar surplus, sufficient to pay benefits for 2.8 years, existed in the Social Security trust funds at the end of the year 2003.**
  - **The surplus is expected to grow to more than $4 trillion by the year 2018.**
- **Most U.S. wage earners pay more Social Security tax than income tax.**
- **Surplus Social Security payroll taxes are being used to pay operating expenses of the U.S. Government.**
- **The 12.4% Social Security payroll tax could be reduced to 9.4% and still cover current benefit payments.**
- **Numbers cited to promote the idea that Social Security is facing a crisis – the alleged 10.4 trillion dollar unfunded obligation and the 16-retiree-per-worker ratio of the 1950s – are deceptive because selected out of context.**

Paul Chadwick, originally from Michigan, has lived on both coasts and traveled extensively in the United States and Europe. Plagued from birth with an analytical mind, he holds degrees in chemistry with high distinction from Wayne State University and molecular biology from Harvard. His career in business spans 30 years, including 22 years managing sales and marketing programs in the scientific supply and instrumentation industry. Since 1996 he has operated his own consulting business. Currently a dedicated California resident and motorcycle-touring aficionado, he provides marketing and design services for a variety of clients. He has written numerous catalogs and product brochures. This is his first book.

Chadwick

IOUs in the Cookie Jar and the Reform of Social Security

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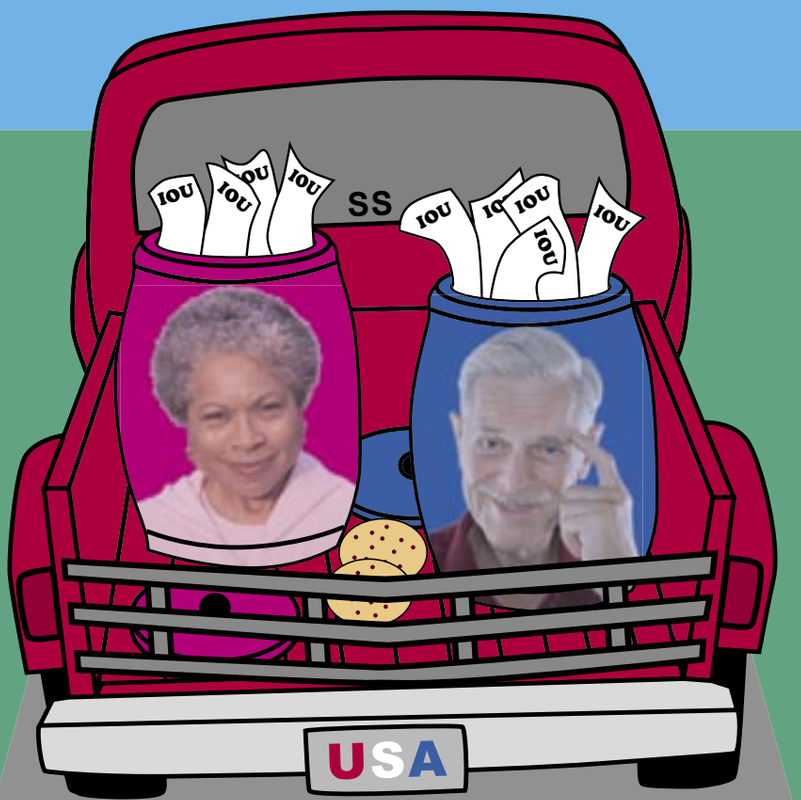
and the Reform of

Social Security



Wherein we attempt to cut the hype and reveal THE TRUTH

Paul Chadwick

IOUs in the Cookie Jar

and

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Contents

For

Daniel Patrick Moynihan

who understood

and for

Pam, Elyse, and Justin

Introduction

Until the last year or so, I, like most Americans, did not spend much time thinking about Social Security. Yes, from my annual W2 tax statements I knew I was paying payroll taxes, FICA, each year. When I was a young boy in the 1950s, my grandparents received Social Security benefits. I remember my paternal grandfather fretting about not being able to earn more than a limit amount by continuing to work part time in his business as a tailored-clothing salesman, otherwise he would lose his monthly benefit. Thankfully, restrictions on earned income that prevented retirees from supplementing their benefits have now been reduced. My parents in retirement lived mainly on my mother's pension from her civil service employment with the State of Michigan. Since her passing, my father, now 88 years old, who worked as an electrical engineer and newspaper deliveryman, lives alone in a rural location and survives on his Social Security benefit. By living inexpensively, he manages, but barely. It is a difficult existence. It is an existence.

The owner of a company for which I worked in the eighties and early nineties frequently complained about having to pay the employer share of the FICA taxes and made a point of having Social Security benefit statements sent to his employees on more than one occasion, so we would know what we were getting as a result of his contributions. I thought it was great that my employer paid half of my FICA tax. I did not appreciate the full impact of the payroll tax until I became self-employed a few years later and began paying the entire tax myself. At that point, I started to find the FICA tax really annoying. But, again, I knew I would be getting something for it in retirement. I trusted the benefits would be a useful supplement to other financial resources and devoted exactly zero time to understanding the details.

Then, a few years ago, I started hearing alarming predictions about the Social Security system going bankrupt, and in 2001, with the incom-

ing Republican administration, the frequency of these dire predictions seemed to increase. There were often stories in the press about Social Security problems. Few details were provided, except that it had something to do with retirement of the baby-boom generation. Finally, I got curious enough to do some research and try to educate myself.

There are not many books about Social Security, except for a few manuals dealing with benefits and how to work through the system in order to obtain them. I was fortunate, however, to find Allen W. Smith's excellent study, *The Alleged Budget Surplus, Social Security, & Voodoo Economics* (2000). Much of the information in this book was updated and incorporated into Smith's later book, *The Looting of Social Security: How the Government is Draining America's Retirement Account* (2004). Smith obviously cares a lot about the Social Security system. His titles are a bit inflammatory, but as I discovered through further research, the information he presented was valid. There are excellent sources of information, many on the World Wide Web, that verify and extend Smith's assertions. These include the web sites of the President's Office of Management and the Budget (OMB) and the Congressional Budget Office (CBO), as well as those of the Social Security Administration and the Internal Revenue Service.

Without attributing evil motives to those who would reform the Social Security system, it appears that there is significant information about the present status and future prospects of Social Security that has not been adequately communicated to the American public. At a time when calls for reform from the administration in Washington are becoming more urgent, it is important for wage-earning taxpayers, all of whom have a stake in the future of Social Security, to be well informed about the real status of Social Security, not just bombarded with the sensational dire predictions that our news media seem to prefer over detailed analysis.

Just as important as public understanding is understanding by members of Congress who must consider and vote on any reform proposals. An assertion by David Kay Johnston in his recently published book about the U.S. tax system particularly concerns me. Johnston writes, "Our federal tax laws are often voted on without any public hearing, without any disclosure of who introduced this or that provision. Members of Congress routinely vote on tax bills they have never read, much less understood even on a superficial level." [1] Shortly after I finished reading Johnston's book, a story hit the national news about a provision in a tax bill under consideration in Congress that would have given congressional staff members access to confidential information in individual income tax returns. The bill almost passed with this provision intact, and the fact that our representatives were not aware that this language had been inserted, by staff members presumably, in a bill on which they were about to vote became a source of significant embarrassment. Perhaps we can not rely on our representatives in Congress alone to look out for our interests as taxpayers and citizens unless they know that we are informed and that we are seriously concerned and watching carefully.

Certainly, a matter as important as Social Security reform requires public debate and serious consideration. It should not be rushed, and it should not be a partisan cabal. In fact, there is no reason to rush, because any projected problems are still significantly removed in the future. It should certainly not be driven by fear and misinformation. Real understanding and rational consideration are mandatory. Thus my compulsion to write this book.

I am concerned mainly with the financing of Social Security, which is the matter to which the most dire predictions have been addressed. For that reason, I deal only briefly with Social Security benefit structure, although some reforms in that area may be useful for improving the financial picture. I am also restricting the subject of this book to the OASDI portion of Social Security, that involved with old age and survivors insurance and disability insurance. An additional component, HI for hospitalization insurance, is also called Medicare. To my mind, HI is more related to issues of national healthcare and will not be considered here.

I also do not intend to dwell on the underlying need for a social security system, which in part resulted from the industrial revolution of the nineteenth century and the resulting migration of a large majority of our population from family-oriented rural settings to corporation-orient-

ed urban life. The dislocation from traditional family structures and indeed deterioration of family structures themselves has been further driven during the twentieth century by rapid transportation, geographic mobility, and corporations that have grown in national and international scope. In addition, there are more people of retirement age simply because we now live much longer on average than we did two hundred or even one hundred years ago. There appears to be general agreement that a social security system of some sort is necessary to replace assurances that might formerly have been afforded the elderly by close family ties.

I am concerned that the vast majority of Americans, who may have a direct stake in the future of Social Security, do not understand the essential facts about the current status of the system and about what is being predicted for the future. This impression has been bolstered by discussions with acquaintances who, for the most part, though reasonably sophisticated in matters of business and finance, seem unaware and amazed when told some of the facts.

Of course, to be informed about a matter of public policy requires interest, which is easier when the matter is perceived to affect one directly and immediately. With regard to Social Security, interest seems to be highest among those who have reached or are approaching retirement age. From the majority of people age fifty or below to whom I have mentioned this subject the typical response is a polite but resounding "Ho. Hum." Clearly for a majority of retirees Social Security benefits are important because they have a major impact on independence and quality of life. For the young, however, retirement is a long way off, and Social Security appears mainly as a tax – one that is collected automatically and for which half the amount is hidden from wage earners on their W2 statements. And nobody in their twenties likes to think much about getting old.

It is not unlike my attitude toward cigarette smoking when I was young. I did it, even though I knew it had detrimental health effects, largely because the most serious detrimental effects were not immediate but delayed in time. And I remember thinking, "I like smoking now, and if I live to be fifty, that's long enough. I'll be happy." In my thirties I

knew I should quit, but rationalized smoking a few cigarettes each day by thinking, "It's not much different from breathing the air in the city." Finally, in my early forties, I got serious and quit smoking completely. Now, at sixty, I wish I had never smoked. I am not reticent about giving advice on this matter when I see young acquaintances light up. Their reaction is typically surprise and a look that says, "What's he getting so worked up about?" It's a lot easier to be concerned about the quality of life after fifty when you are sixty than when you are twenty.

To obtain understanding for issues like cigarette smoking and social security that span the stages of our lives, it is necessary to get people in different age groups to communicate and trade places mentally. Those of us at or near retirement age need to think not only as retirees, but also imagine we are wage earners in our twenties or thirties. Not too difficult, perhaps, since most of us have been there. And those in their twenties and thirties need to take interest and try to imagine their situation when they are fifty-plus and approaching retirement. Definitely the more difficult task, I suppose. Only then can we obtain a proper understanding across our population of issues that are important to all of us but have costs and benefits widely separated in time as they affect our own lives. We live in a "now" society, but ignoring national policy and retirement planning when you are young is just as likely as smoking to be detrimental to the quality of your life when you are older. That issues surrounding Social Security involve financial concepts of significant complexity makes understanding by the young even more difficult, as I have discovered in discussing the draft for this book with my children. Perhaps getting us all talking about it is the most significant contribution of the Bush administration in pushing for changes.

This book is an attempt to focus on the finance of Social Security in a succinct and hopefully easily readable form that will contribute to understanding and rational consideration and help assure that any changes made to the U.S. Social Security system are beneficial, not accidentally detrimental to the American public. I have provided summaries after all but the first and last chapters, and a proposal after the last. For a quick look at the information presented, the reader is invited to simply jump to the summaries.

Chapter 1

A Parable

An acquaintance of mine, John, and his wife Tamara[1], were blessed with a young son. Knowing that the expense of a college education would eventually become an issue they decided to imbue the boy with a sense of responsibility and an understanding of the need to plan for the future.

They purchased a large blue cookie jar and made a compact with their son. The boy agreed to draw from his allowance or earnings from summer and after-school employment ten dollars each week and place it in the jar. If he performed this task faithfully, in return his parents promised that when the time came for college they would bear the full amount of his tuition as well as such living and entertainment expenses that might exceed his ability to support himself by his own labors.

It might have seemed reasonable periodically to place the balance from the cookie jar in a secure savings account drawing interest or otherwise invest the fund in stocks and bonds. But the parents had another plan. Why risk their son's college fund or provide the benefit of its use to others, they reasoned, when they could just as well guarantee it themselves and meanwhile make use of the money to enhance their lifestyle?

Each month, therefore, they determined to remove from the jar the cash that had been deposited and replace it with a written IOU. In addition, desiring to assure their son a fair return on his investment, at the end of each year they would insert in the cookie jar an additional IOU for interest in the amount of five percent of the total of all previous IOUs contained there. The boy assented to this plan, fully trusting his parents to make good on the IOUs when the time to spend for college arrived. The cash removed from the jar provided a modest contribution to the family's needs, without which they might have had to earn more or to borrow more in order to support themselves, or to moderate their lifestyle.

As the years went by the cost of a college education increased. The parents convinced their son to increase his weekly contribution by five dollars, to fifteen dollars per week, and then again later to twenty. Although the additional contributions put a strain on the son's finances and limited his enjoyment of the money he earned from part-time employment, he knew it was for a good cause and was worried about the increasing cost of a college education, therefore readily assented. Had it not been for the additional contributions to the cookie jar, the boy might have had enough money to start a separate savings account for himself at the local bank. Nonetheless, he trusted his parents and knew he would come out even in the end. In reality, if the extra money had not gone into the cookie jar, he probably would have spent it.

Another couple in the neighborhood, Tim and Celine[1], heard of this plan and thought it was a good idea. They had a daughter who would reach college age about the same time as John and Tamara's son. They also purchased a large cookie jar (a pink one) and convinced their daughter to accept the same arrangement.

Tim and Celine's daughter actually managed to earn more from babysitting and summer employment than John and Tamara's son was able to earn during his school years, so the cookie jar contributions were less taxing to her. Still, she was not inclined to save her additional funds, but preferred to spend them on clothes and entertainment, knowing that her parents' commitment and the cookie jar balance would cover her college years.

When college time arrived, there was nothing but IOUs in any cookie jar.

As their son grew, John and Tamara enjoyed abundant success. They focused their energy on building careers, and their family had a good life, but not extravagant. When the time for college arrived, they had no problem making good on the IOUs in their son's cookie jar, and their son was able to live away and attend a first-rate college. Even though the

cost of college had increased more than expected, John and Tamara were able to pay for their son's college years completely from current income without borrowing a dime. Between his parents' contributions and their return of the cookie-jar funds, the boy had no need to work while attending college and was free to concentrate completely on his studies and social life.

In contrast, while Tim and Celine's daughter matured, their family was not so fortunate. Tim and Celine worked hard, but not smart, and never seemed to earn enough between them to make ends meet. Use of the cookie jar money helped them meet some expenses, and they tried to live cheaply, even slighting some important needs such as health care and repairs to their house. In spite of that, the family went into debt and owed a little more at the end of each year than at the end of the last. Occasional binge trips to Las Vegas, borne of frustration and the fantastic hope of finding gratuitous fortune did not help the situation. Responding to incessant marketing campaigns from big corporations, they took out consumer loans and bought an amazing home entertainment system and a gas-guzzling Hummer they could not really afford (but it made them feel dominant on the highway). This generated excitement and took their minds off their problems and otherwise dull lives. The IOUs in the cookie jar became just one debt among many. If the cookie jar funds had not been available, Tim and Celine might have been more frugal. But more likely they would have borrowed more and ended up in even worse financial condition.

As the time for college approached, Tim and Celine sat down with their daughter to discuss reality. Fortunately, all three of them were strongly committed to the importance of a college education. Otherwise, it could have been abandoned.

Instead of going away to school, their daughter settled on a local commuter college and continued to live with her parents through most of her college years. She opened a bank account and began saving what money she could from her after-school earnings during high school. She delayed college to work full-time for a year. During college she continued working part time. Tim and Celine sold the Hummer and bought an old car and by looking carefully at their budget found a few other expenses

to cut. Celine took a second part-time job. They avoided taking out any college loans because they didn't want their daughter to be saddled with debt after college. The program worked. Between slightly reduced expectations, a little sacrifice, some delay, a little more work on the part of both parents and child, and a couple of years of part-time study, Tim and Celine's daughter managed to complete four years of college in five years and obtain a grant for graduate study.

The girl became a successful research scientist and is part of a team that is making major advances in early diagnosis and treatment of Alzheimer's disease. John and Tamara's son embarked on a lucrative career as a programmer with a Silicon Valley software company. In the fourth year of his employment his job was outsourced to a software service firm in India at one-third the cost. After a six-month extension to train his replacement in the programming group, he became one of Starbuck's most valued employees.

What effect did the cookie jar have on John and Tamara's ability to finance their son's college education? Very little, looking at it objectively. With the favorable development of the family fortunes, John and Tamara were easily able to finance college for their son. If there had been no cookie jar at all, their son's college years would have been much the same.

In truth, the contributions to the cookie jar did teach their son a degree of frugality and made him appreciate the need to think about his future. But the extra contributions in the later years severely impacted his social life while in high school and gave him less to show for his labors after school and in the summertime than he might otherwise have enjoyed. It also deprived him of some degree of choice between spending or possibly making his own investments on the side and thereby gaining some additional discipline and experience in finance. Without the benefit of the cookie jar funds, John and Tamara might have enjoyed a few less material possessions during the years of their son's development, but the slight positive impact on their lifestyle really was not significant.

What effect did the cookie jar have on Tim and Celine's ability to send their daughter to college? Objectively, virtually none. The cookie jar IOUs became one more debt among many. In the final analysis, financing their daughter's education depended on a willingness to lower expectations, a commitment by Tim and Celine as well as their daughter to hard work, and some adjustments to scheduling. While less than ideal, these measures accomplished the objective and permitted their daughter to pursue her education successfully.

In the final analysis, the ability of either couple to see their offspring through a successful college experience depended primarily on the financial health and financial growth of the family when the college years arrived and had virtually nothing to do with the cash deposited in the cookie jar. The cookie jar made each child aware of the need to think ahead toward their college years with concern toward how to pay the bills, but otherwise had virtually no effect on success in paying the college bills.

John and Tamara as well as Tim and Celine are fictitious characters. I made them up. Any similarity to real people is purely coincidental.

But the issues represented by their concerns for anticipated future expenses and their wisdom or lack of it in adopting the device of the cookie jar to deal with them are real.

"Stupid!" you may say. Who in their right mind would come up with the idea of filling a cookie jar with IOUs and expecting this to have an effect on the ability to meet future obligations? Much better if the cash had been left in the cookie jars or, better yet, invested in an interest-bearing account.

Agreed!

But the entire rationale for this absurd little parable is the U.S. Social Security system.

The Social Security Trust Funds (OASI and DI) work exactly like John and Tamara and Tim and Celine's cookie jars.

Chapter 2

Federal Trust Funds: How They Work

The popular idea of a trust fund is rooted in private commerce and personal finance.

"Trust" has many meanings. As a noun it can mean confidence or belief in the integrity of a person or occurrence. It can also mean a business combination for the purpose of creating monopoly, usually illegal.

As a verb it means what you do when you believe in something or someone.

As an adjective, for example as used in "trust fund," it means "held in trust" as in money or capital equity stock held by a "trustee," a trusted person, and usually dedicated for a specific purpose. A trust fund may be held for the purpose of funding a charity or for the purpose of dedicating assets to an offspring. But, in general, there are specific assets, money or certified investments, contained in or dedicated to the trust fund.

U.S. Federal Government "trust funds" in some respects are similar, but also fundamentally different.

Federal Government trust funds include the Social Security Trust Funds, also known as the Old Age and Survivor Insurance (OASI), and Disability Insurance (DI) funds (often referred to in combination as OASDI), and the Federal Highway Trust Fund, among others. These trust funds were created by law and intended to assure that specific revenues – those obtained from certain special taxes – are used for specific purposes.

There is no physical cookie jar holding a Federal Government trust fund, and there is no cash actually contained in the fund. The trust fund and its income, expenses, and balance are defined purely by accounting procedures.[1]

A brief overview of operation of the federal budget may be useful to understanding:

All tax revenues received by the U.S. Government, *from whatever source*, flow to the U.S. Treasury accounts. All payments by the U.S. Government, *for any purpose*, are made in the form of checks drawn on these U.S. Treasury accounts.

Just as with your personal checking account, balances in the U.S Treasury accounts must be sufficient to cover payments. If tax revenues were to exceed payments, there would be a surplus in the accounts. If payments exceed tax revenues, which is most often the case, the U.S. Treasury must raise the difference by borrowing. It does this by issuing U.S. Treasury bonds and selling them to the public. *The public* includes institutions and private individuals, both domestic and foreign, that invest in U.S. Treasury bonds of their own free will and volition.

Revenues generated by the sale of U.S. Treasury bonds are deposited in the same U.S. Treasury accounts as tax revenues. A U.S. Treasury bond is a promise to pay back, at a defined future date (the *maturation date*), the amount paid by the purchaser of the bond plus interest. U.S Treasury bonds may be traded on the open market. The proceeds of principal and interest are paid to the current owner when the bond matures, but in any event are the same as the amount agreed – the *face amount*, which includes principal plus interest – when the bond was originally sold by the U.S. Treasury. Treasury bonds are sold at auction. The amounts received and interest owed are subject to market forces.

Interest on U.S. Treasury bonds is an additional expense of the U.S. Government. It appears as *net interest* in federal budget accounting reports.[2] The total principal amount of U.S. Treasury bonds outstanding at any given time is called the *public debt* of the U.S. Government. The net amount that must be borrowed from the public to cover expenses in excess of tax revenues in a given year is called the *federal deficit* or *federal unified-budget deficit*.

Of course, in any given time period the U.S. Treasury must pay out funds to redeem existing U.S Treasury bonds that reach maturity. These payments for debt redemption must also be covered by new borrowing. Thus, in addition to any deficit in current operations, the U.S. Treasury

must *turn* the debt represented by U.S. Treasury bonds maturing during the period. The total amount that must be raised from new bonds sold to the public is equal to the current period deficit plus the amount necessary to turn existing public debt that reaches maturity.

The prices for which U.S. Treasury bonds can be sold at auction are a function of supply and demand. As the amount borrowed by the sale of bonds increases, the added supply tends to drive down the price that can be obtained by the U.S. Treasury for bonds of a given face value, thereby increasing the interest expense. Persistent deficits require increased borrowing and tend to drive up interest rates on the public debt of the U.S. Government. If there were to be a surplus of tax revenues over expenses in the federal budget, this would allow a corresponding amount of public debt to be retired without new borrowing. The decreased borrowing, therefore lower supply of U.S. Treasury bonds at auction, would tend to increase the price of U.S. Treasury bonds and decrease the interest rate of U.S. Government public debt. This has occurred rarely in recent years.

Other borrowers, whether businesses or individuals seeking mortgage loans, must compete with the U.S. government for funds. When high rates of government borrowing drive up interest rates, interest rates for mortgages and business loans tend to increase also. And vice versa, when the U.S. Government borrows less, interest rates on U.S. Treasury bonds fall and money becomes more readily available at lower interest rates for other borrowers, thereby favoring investment and growth in the private sector.

Now let's ignore the overall operation of the federal budget for a moment and concentrate on trust funds:

Government accountants in the U.S. Treasury Department keep track of how much revenue is received from each source. Amounts received from taxes allocated for specific purposes such as Social Security, as required by law, are assigned by the accounting system to specific trust funds. For example, the amount of revenues generated by the FICA (Federal Insurance Contributions Act) payroll taxes paid as a percentage of wage and salary compensation by workers and their

employers is credited in designated proportion to the Social Security trust funds. A smaller designated proportion is credited to the Medicare Fund. Self-employment taxes paid as a percentage of earnings by self-employed persons are similarly credited to the Social Security and Medicare trust funds. The amount of revenues from federal gasoline taxes is credited to the Federal Highway Trust Fund, and so on for others.

Expenditures for which a trust fund is dedicated, for example Social Security benefit checks as well as administrative expenses, are also tracked by accountants and charged against the fund account. Each year, ideally, the revenues and expenses for a trust fund would balance. The inflow from allocated tax sources and the outflow of covered expenses would be nearly equal. If inflow were to exceed expenses slightly, there would be a small surplus in the trust fund account at the end of the year. If expenses were to exceed inflow slightly, the trust fund would run a small deficit. Since all payments are made by checks drawn on the U.S. Treasury, if there were no balance in the Social Security Trust Fund the small deficit could be made up from general revenues. There is one small proviso: by law, funding any excess Social Security expense from general revenues requires approval from Congress.

As long as the accounting deficits and surpluses in a trust fund are small, they do not present a problem and may balance out from year to year. However, large deficits in a single year or a sustained series of annual deficits that result in a large cumulative deficit would be a problem for any trust fund. The existence of large deficits would mean that the taxes allocated to the expenses for which the trust fund is dedicated are not generating sufficient revenue. Since, as mentioned at the beginning of this chapter, *all payments by the U.S. Government, for any purpose, are made in the form of checks drawn on the U.S. Treasury accounts*, this means that a significant portion of the dedicated expenses must be paid from general revenues. To do so may require special authorization by Congress. This is probably not what Congress intended when the trust fund was established.

Solutions to this problem would include reducing expenses in situations where expenditures are flexible, as with the Federal Highway

Trust Fund, for example. In cases where expenses are dictated by a formula that is less flexible, as with Social Security payments, the solution might be to change the tax rates or tax structure in a way that raised more revenue. Over the 50 years from 1935 when the Social Security system was established until the mid-1980s, revenues from payroll taxes were successfully managed so that on a year-to-year basis inflow was approximately equal to outflow. A small positive balance was maintained in the trust funds, and no significant deficits or surpluses existed.

Large surpluses or cumulative surpluses from year to year in a federal trust fund represent an opposite problem. Surpluses indicate either that the taxes intended to pay the specific expenses for which the trust fund is dedicated are too high, or that programs to which the trust fund is dedicated are not aggressive enough in using the funds as intended. Where expenses are flexible, as in the case of the Federal Highway Trust Fund, the latter might be assumed to be the case, and the solution might be to increase the number of projects funded. Where expenses are relatively inflexible, as in the case of Social Security benefits, the logical solution might be to decrease the tax rates to bring revenues into line with expenses. (For more detailed information, see Chapter 3.)

Unfortunately, with the Social Security trust funds, other factors have intervened to prevent the logical solution from being implemented.

As mentioned at the beginning of this chapter, *all tax revenues received by the U.S. Government, from whatever source, flow to the U.S. Treasury*. A surplus of trust fund revenues over expenses therefore means that the excess revenues flow into the general U.S. Treasury fund, contribute to the balance in the U.S. Treasury account, and can be used to pay general U.S. Government expenses. This also is probably not what Congress intended when the trust fund was created.

Although payroll taxes at modest levels were sufficient to cover Social Security outlays for benefits during the first 30 years of the program, concerns about changing demographics started to arise in the 1960s. Advances in medicine were increasing the average life span of Americans at the same time that the baby-boom generation resulting

from the high birth rates succeeding World War II was coming of age, and birth rates were declining. The short-term concern was that retirees living longer and statutory increases voted by Congress would increase the expense of Social Security benefits and would require some increases in the payroll tax to prevent deficits in the trust funds. A longer-term concern was that when the baby boom generation reached retirement age the number of workers per retiree, because of declining birth rates, would also decline, requiring even larger tax increases to keep the trust funds in balance.

Congress passed legislation in 1972, during the Nixon administration, that made some adjustments to the Social Security system. Among the adjustments were a programmed series of increases in the payroll tax rates allocated to OASDI from the 3.45% applicable in 1972 culminating in a rate of 6.2% each for employees and employers in years 1990 and beyond. In addition, a system of automatically increasing Social Security benefit payments in relation to the U.S. consumer price increase – COLA (Cost Of Living Adjustments) – was created.[3] The maximum wage to which the payroll tax would apply was also set to adjust automatically for years after 1974.[4]

In 1981 President Ronald Reagan and Congress appointed a commission headed by Alan Greenspan, therefore called the Greenspan Commission, to study and make recommendations for keeping the Social Security system solvent. The Greenspan Commission made recommendations for keeping the Trust Fund in balance in the short term, including some adjustments to benefits, minor adjustments in the rates programmed by the 1972 legislation, a substantial increase in the tax paid by self-employed persons, and programmed increases in the full-benefit retirement age from 65 to 67 years to occur after the year 2000.[5] The Greenspan Commission did not recommend any alteration to the COLA provisions for benefits or the maximum wage subject to payroll tax, and the final programmed payroll tax rate of 6.2% scheduled for 1990 was left in place. The recommendations of the Greenspan Commission were enacted by Congress in 1983.

No significant adjustments to the payroll tax rates have been made since 1983. However, a few changes in rules governing qualifications for

benefits were made during the 1990s. One of these, the removal of restrictions on earned income by benefit recipients, had the effect of increasing benefit payments in the short term.[6]

Beginning in the late 1980s and continuously since, the Social Security trust funds showed significant surpluses, indicating that the rate structure adopted by Congress in 1972 had miscalculated and overestimated the revenue requirements. Ideally, once this was realized, Congress might have acted to revise the tax rate downward in order to bring the system back into balance. This did not happen, for two reasons.

The first was the existence of long term actuarial projections indicating that the Social Security trust fund would begin to show outflow in excess of revenues under the existing rate structure in the year 2018. In the face of these predictions, the idea became prevalent that it would be useful to build a "surplus" in the trust fund in anticipation of future shortfalls, so that after the year 2018 payroll taxes could at least remain at existing levels even while allowing payments of benefits to exceed dedicated revenues.

The second was the fact that the Federal Government was operating with consistently high deficits during the 1980s continuing into the 1990s. The surplus from the Social Security trust funds helped to offset these deficits, decreasing the amount that the U.S. Treasury had to borrow from the public and moderating the need for other tax increases or adjustments to spending. From a political standpoint, it was easier to leave in place the excess payroll tax rates that wage earners and their employers had become accustomed to paying, rather than decrease those rates and attempt offsetting increases in general and corporate income taxes.

Consequently, payroll tax rates were not adjusted and the Social Security trust funds continued to show increasing surpluses year after year. In the face of rampant talk about bankruptcy and insolvency, many readers may be surprised to learn that the Social Security trust funds currently contain a very substantial surplus, the details of which will be discussed in Chapter 3.

With regard to the long-term requirements of the Social Security system, especially with payments predicted to exceed payroll tax revenues after the year 2018, it might have made sense to maintain surpluses in the Trust Fund but put them in a "lock box" as Vice President Albert Gore suggested during the 2000 presidential election campaign. What is a lock box? This could have meant using the surpluses in the Social Security trust funds to pay down other Federal Government debt or to reduce borrowing from the public. As we shall see, however, balances in the trust funds already have this effect, by law. So the real issue is the overall level of government spending relative to revenues, not simply how the trust fund balances are allocated. Alternatively, it could have meant setting the surpluses aside in a separate account that could be invested and not used to pay other government expenses. This, of course, would have exacerbated the overall U.S. Government financing challenge, requiring the U.S. Government to better balance expenditures and taxes or the U.S. Treasury to borrow more money from the public and thereby substantially increase the public debt.

And how would the funds in the lock box be invested? They could be deposited in Federal Reserve Banks and made available for loans to member banks. But the discount rate for funds loaned by the Federal Reserve Bank to member banks is low compared to other interest rates in the U.S. market, so this would not be a very lucrative investment. On the other hand, investment in certificates of other banks or stocks and bonds would carry the possibility of bias or favoritism. It would involve additional risk. Also, for the U.S. Government to trade in the stocks of corporations public or private would be a deviation from historical free-market capital tradition in the United States.

So, instead, the surplus in the Social Security trust funds is mandated by law to be invested in special-issue U.S. Treasury bonds. These bonds cannot be publicly traded. They are essentially cookie-jar IOUs that obligate the U.S. Treasury to pay back at some future date the amounts allocated to the fund but spent for other purposes. The special bonds pay interest at competitive rates. The interest is paid in the form of additional special U.S. Treasury bonds, i.e., more cookie-jar IOUs. The

special Treasury bonds in the Social Security trust funds represent money borrowed by the Federal Government from itself. As such, they do not represent real debt, but merely a record of the transfer of monies from the purpose for which they were intended to use for other purposes. There is an implied understanding that at some future date these monies will be restored.

The amount outstanding for special-issue U.S. Treasury obligations issued to the Social Security trust funds and other trust funds is added to the public debt of the U.S. Government to arrive at a total figure for the national debt. As of the year 2004, such special-issue bonds represent about 40% of the national debt total.[7]

The special-issue bonds held in the Social Security trust funds are significantly different from the U.S. Treasury bonds sold to the public. First, they cannot be traded in secondary transactions nor can they be sold to the public. Their value, therefore, is fixed and not subject to market forces. Second, these bonds purport to represent money that the government has borrowed from itself.

There is only one problem with this procedure. The money in the Social Security trust funds came from payroll taxes paid by wage earners, their employers, and self-employed people with the understanding that it would be used to pay Social Security benefits and only for that purpose. It can be removed temporarily, but must be replaced if needed in the future to pay benefits. But once the funds removed have been spent on other things, how are they to be repaid when needed?

Several possibilities exist.

One would be to convert the money the U.S. Treasury owes to the Social Security trust funds to public debt when it is needed to pay benefits, by current projections in the years 2018 and beyond. This could be done by selling additional U.S Treasury bonds at public auction. Depending on the size of the public debt of the U.S. Government at the time, this might require raising statutory limits on borrowing by the U.S. Treasury and it could possibly have adverse effects on interest rates.

Another option would be to retire the internal debt with funds from general taxation. This might require raising income taxes or increased taxes from some other source. If we're lucky, other government expenses might be reduced to allow the restoration of the borrowed funds with existing tax levels. Given our recent history, how likely is that?

A good deal of hand-wringing about the problem of potential insolvency in the Social Security system has to do with this problem, projected to begin in the year 2018. As will be discussed in detail in the next chapter, the news media are all too ready to pick up on this hand-wringing. Dire predictions of insolvency become the rationale of proposals for modifications to the Social Security system. Alarms voiced by Federal Reserve Chairman Alan Greenspan about solvency problems trumpet the need to take action, including possibly restricting future benefits. President George W. Bush calls for privatization of at least a portion of the Social Security system so that Americans can "own their own retirement accounts." The latter proposal is at least interesting in view of the fact that the "retirement accounts" currently owned by the Federal Government have been paid for specifically by taxes on the wage earners to whom the Government owes the benefits.

Alas, we come back to the definition of the word "trust" as it applies to the Federal Government and the Social Security system.

It becomes clear: trusting the Federal Government is what workers who have paid payroll and self-employment taxes must do if they are to be assured of the old age, survivor, and disability benefits that they were promised would accrue from the Social Security system. And trust is what requires the Federal Government, at the very least, to repay the funds that have been borrowed from the Social Security Fund when they are needed. Balances in the Trust Fund are really cookie-jar IOUs like those placed by my fictitious friends in the first chapter. They have essentially no impact on the ability of the Federal Government to pay benefits through the Social Security system at future times when they are needed. But they do document the willingness of American workers to pay taxes in order to assure some level of sufficiency after retirement,

and they do document the commitment of the Federal Government to provide a baseline assurance of sufficiency to every worker who has contributed.

This is a trust that must not be broken.

Professor Allan W. Smith has called the use of the surpluses in the Social Security trust fund to pay general government expenses "The Looting of Social Security." [8] I believe the situation is not quite that sinister.

It is, instead, a matter of fiscal discipline.

The existence of Social Security trust fund surpluses has become a convenience for the Federal Government. Our leaders have lacked the fiscal discipline to deal responsibly with this situation. The "trust" in "Social Security trust fund" requires our leaders, present and future, to develop that discipline.

Summary

- All federal tax revenues, including the Social Security payroll taxes, flow to the U.S. Treasury.
- The Social Security trust funds exist only as accounting devices.
- The Social Security trust fund balances are represented by special U.S. Treasury notes: essentially IOUs from the U.S. Government.
- In the future, when Social Security trust fund balances are needed to pay benefits, money to redeem the special Treasury notes must be obtained either by increasing other taxes or borrowing from the public.

Chapter 3

Current Status and Projections

Recent reports in the news frequently state that the Social Security system is in financial trouble: that Social Security is facing a crisis. Words one often hears are "bankrupt" and "insolvent" with regard to the Social Security trust funds.

Citing the upcoming retirement of the baby boom generation, these stories stoke fears that the current Social Security system is in danger of going broke. It is said that unless the system is changed, and soon, Social Security will fail, that the Trust Fund will "run out of money" and that this will happen at some time in the not too distant future. Dates frequently mentioned in connection with this projected event are the years 2018 and 2042. The year 2078 also sometimes turns up.

Where do these dates come from, and what do they mean? Our news media seldom address these questions with any reasonably coherent information, choosing instead to simply repeat the dire predictions while offering little insight or explanation. Unfortunately, constant repetition creates the illusion of validity even in the absence of supporting facts. For suspicious minds, this publicity might appear to have the characteristics of a manufactured frenzy, created to serve the purposes of some ulterior agenda.

The dire predictions are given more weight by no less a personage than Alan Greenspan.[1] Remember Alan Greenspan? Alan Greenspan headed the commission appointed by President Reagan in 1981 to make the recommendations for saving Social Security that were enacted by Congress and signed into law over twenty years ago. Of course, in his most recent role as Chairman of the Board of Governors of the Federal Reserve, Greenspan has gone on to develop tremendous credibility. In fact, the name Greenspan has become almost synonymous with health of the U.S. economy. The financial markets hesitate and shudder at Alan

Greenspan's pronouncements. We would be wise, at least, not to ignore Greenspan's warnings about Social Security.

Changes often mentioned are *limiting benefits* and *privatization*.

Given that it's 2005, however, the years 2042 and 2078, even the year 2018, seem rather far away. In fact, given that our Federal Government has difficulty accurately projecting budgetary conditions only a handful of years into the future, the validity of predictions for the financial status of an important component of the Federal budget fourteen or thirty-eight or seventy-five years out might be subject to some question. Remember, only four years ago we were projecting large Federal budget surpluses, and now we are saddled once more with budgetary shortfalls in excess of 400 billion dollars per year. If our government economists can't even get the near future right, how can they be so certain about more distant events?

Some experts predict that the world will begin to run out of oil that can be easily extracted from the ground in the not too distant future.[2] This could happen even before the year 2018, or perhaps not very long thereafter. In fact, the Hubbert Peak method, invented by Shell Oil Company geophysicist M. King Hubbert, on which such predictions are based, has previously demonstrated validity by predicting, during the 1950s, the peak in North American petroleum production that occurred virtually on schedule in 1970. Given the dependence, in fact the increasing dependence, of the U.S. economy and the world on petroleum supplies, doesn't the possibility of running short of oil have even more dire consequence than financial difficulties of Social Security?

I mention this only to underscore that there are many things that are uncertain about the U.S. economy in future years. The financial status of the Social Security system is only one of them. We need to worry about Social Security. But we also need to worry about security in general and in relation to the U.S. and the world economy as a whole. We can, for purposes of analysis, look at Social Security in isolation and make predictions. However, predictions may have little validity if they fail to take into account how one component of our economic well-being will relate to the greater question of overall well-being in the future. Lest we lose perspec-

tive, should we not be concerned about other future economic matters to at least the degree that we are concerned about Social Security?

The most frequently mentioned possibility for reform of the Social Security system, and the one promoted by the current administration in Washington, is some sort of privatization of Social Security accounts. Privatization is generally understood to mean operation of all or part of the Social Security system by some mechanism other than the current federal Social Security Administration or investment of some portion of Social Security trust fund assets in instruments other than the currently allowed special issue U.S. Treasury bonds. Such instruments might include publicly traded bonds, equities, or mutual funds.

As of this writing, full details of the Bush Administration's proposals for the reform of Social Security have not been revealed. President Bush has, however, expressed the idea that reform should involve individual "ownership" of retirement accounts as one answer to the projected shortfalls of the current government-sponsored Social Security system. There seems to be an implicit belief that a privatized system would be superior to a public system, although little evidence aside from faith has been adduced to support this.

An oft-heard mantra in the popular press is the assertion that privatization of Social Security will cost two trillion dollars and the question: where will this money come from? But once again specifics to support or explain these concerns are sadly lacking. Essentially, current press coverage consists of reproducing the scare tactics of the various factions involved in the thrust for Social Security reform. The scare from the proponents of privatization is the notion that the Social Security system is borderline insolvent and soon to go bankrupt if not changed. The scare from opponents of privatization is the prohibitive cost. The press is long on fear and short on specifics.

Scare tactics often work, and fear is a great motivator. But actions taken in fear without properly understanding a situation have the possibility of making things worse, or at least not better. The U.S. Social Security system owes its inception to legislation passed by Congress in 1935. It was one part of the solution to problems created by economic

collapse and the Great Depression of the early 1930s. President Franklin Delano Roosevelt, generally regarded as the father of Social Security, in his first inaugural address on March 4, 1933, stated his belief that "the only thing we have to fear is fear itself – nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance." [3] Perhaps an overstatement for our situation today, but the same principle should apply.

So let's get real.

Where do we actually stand with reference to Social Security income, outlays, surpluses and balances?

A little history may help. Each year the Board of Trustees of the OASI and DI trust funds, as required by law, transmits a comprehensive report to Congress. The report for the year 2004 contains a wealth of historical data as well as current summaries of the operations of the Social Security system and projections for the future, both short-term and long-term.[4]

Table 3.1 presents historical data selected from Table VI.A2, "Historical Operations of the OASI Trust Fund, Calendar Years 1937-2003," found on page 129 of the 2004 Trustees' Report, and Table VI.A4, "Historical Operations of the Combined OASI and DI Trust Funds, Calendar Years 1957-2003," found on pages 133-134. Data for calendar years up to and including 1956, prior to the separate existence of the DI trust fund, are taken from the first table and for years from 1957 onward from the second.

Because this data is compiled from years past, it can be regarded as representing the true course of events up to and including the past year with a very high degree of accuracy. The numbers cited in Table 3.1 are for the combined OASI/DI trust funds. These funds represent the operation of the Social Security system as regards retirement, survivor, and disability benefits. They do not include the HI (hospitalization insurance) components commonly known as Medicare. *

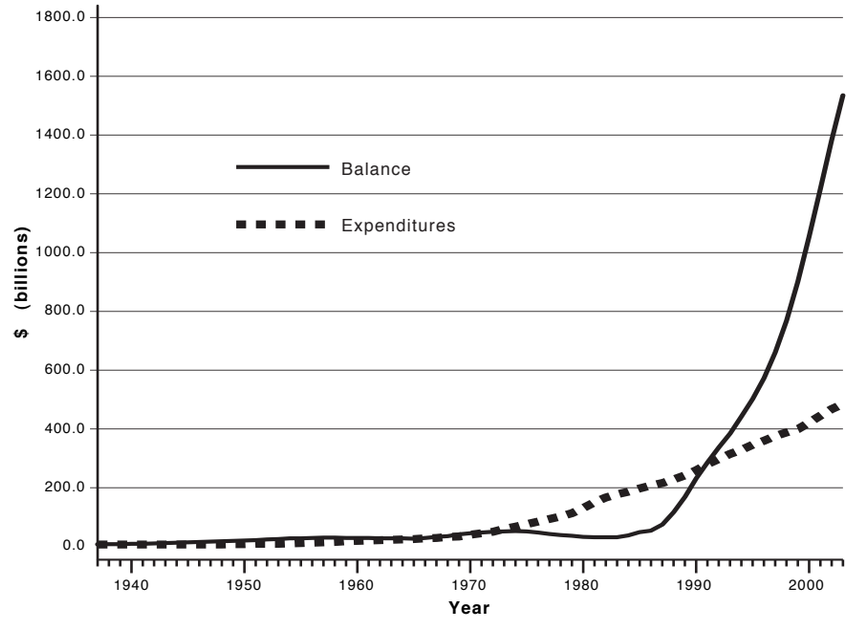
* As noted in Introduction, for purposes of clarity and brevity I have restricted the subject matter of this book to the retirement and disability aspects of Social Security. The HI trust fund and related operations more properly fall into the category of national health care and should be regarded as a separate subject.

Table 3.1. Historical Data ($Billions), Combined OASI and DI Trust Funds

Year	Expenditures	Income	Surplus	Fund Balance
1937	0.0	0.8	0.8	0.8
1938	0.0	0.4	0.4	1.1
1939	0.0	0.6	0.6	1.7
1940	0.1	0.4	0.3	2.0
1941	0.1	0.8	0.7	2.8
1942	0.2	1.1	0.9	3.7
1943	0.2	1.3	1.1	4.8
1944	0.2	1.4	1.2	6.0
1945	0.3	1.4	1.1	7.1
1946	0.4	1.4	1.0	8.2
1947	0.5	1.7	1.2	9.4
1948	0.6	2.0	1.4	10.7
1949	0.7	1.8	1.1	11.8
1950	1.0	2.9	1.9	13.7
1951	2.0	3.8	1.8	15.5
1952	2.3	4.2	1.9	17.4
1953	3.1	4.4	1.3	18.7
1954	3.7	5.6	1.9	20.6
1955	5.1	6.2	1.1	21.7
1956	5.8	6.7	0.9	22.5
1957	7.6	8.1	0.5	23.0
1958	8.9	9.1	0.2	23.2
1959	10.8	9.5	-1.3	22.0
1960	11.8	12.4	0.6	22.6
1961	13.4	12.9	-0.5	22.2
1962	15.2	13.7	-1.5	20.7
1963	16.2	16.2	0.0	20.7
1964	17.0	17.5	0.5	21.2
1965	19.2	17.9	-1.3	19.8
1966	20.9	23.4	2.5	22.3
1967	22.5	26.4	3.9	26.3
1968	26.0	28.5	2.5	28.7
1969	27.9	33.3	5.5	34.2
1970	33.1	37.0	3.9	38.1
1971	38.5	40.9	2.4	40.4
1972	43.3	45.6	2.3	42.8
1973	53.1	54.8	1.6	44.4
1974	60.6	62.1	1.5	45.9
1975	69.2	67.6	-1.5	44.3
1976	78.2	75.0	-3.2	41.1
1977	87.3	82.0	-5.3	35.9
1978	96.0	91.9	-4.1	31.7
1979	107.3	105.9	-1.5	30.3
1980	123.6	119.7	-3.8	26.5
1981	144.4	142.4	-1.9	24.5
1982	160.1	147.9	0.2	24.8
1983	171.2	171.3	0.1	24.9
1984	180.4	186.6	6.2	31.1
1985	190.6	203.5	11.1	42.2
1986	201.5	216.8	4.7	46.9
1987	209.1	231.0	21.9	68.8
1988	222.5	263.5	41.0	109.8
1989	236.2	289.4	53.2	163.0
1990	253.1	315.4	62.3	225.3
1991	274.2	329.7	55.5	280.7
1992	291.9	342.6	50.7	331.5
1993	308.8	355.6	46.8	378.3
1994	323.0	381.1	58.1	436.4
1995	339.8	399.5	59.7	496.1
1996	353.6	424.5	70.9	567.0
1997	369.1	457.7	88.6	655.5
1998	382.3	489.2	107.0	762.5
1999	392.9	526.6	133.7	896.1
2000	415.1	568.4	153.3	1049.4
2001	438.9	602.0	163.1	1212.5
2002	461.7	627.1	165.4	1378.0
2003	479.1	631.9	152.8	1530.8

In the interest of better understanding I have taken liberties with the labeling and ordering of the historical-data columns. The columns in Table 3.1 labeled "Expenditures" and "Income" represent the total expenditure and income data from the Trustees' Report, albeit in reversed order of presentation. The column labeled "Surplus" represents the excess of income over expenditures for each calendar year. It contains the same data as the column labeled "Assets: Net increase during the year" from the Trustees' Report. The difference in labeling here might be attributed to my particular bias toward focusing on the dynamic operational aspects of the Social Security system rather than accumulation of "assets." As the reader may already surmise, I tend not to regard these assets as real. More about that later. Finally, the column labeled "Fund Balance" in Table 3.1 is the same as that labeled "Assets: Amount at end of year" by the Trustees. OK! This table is pretty dry. If you don't have much taste for this sort of thing, you might want to just skip to Figure 3.1, which summarizes the data from the table in perhaps more palatable form.

Figure 3.1. Historical Data, Combined OASI and DI Trust Funds



With the columns of Table 3.1 labeled properly, we can throw away columns #3 and #4, "Income" and "Surplus" as existing primarily for purposes of calculation. The data in columns #1, #2 and #5 are presented in Figure 3.1 for better visualization.

What happened here?

Looking at the historical OASDI Trust Fund balance (solid line in Figure 3.1), it is clear that from the inception of Social Security and for approximately the first 45 years of the program a small positive balance was maintained in the trust funds. This was basically sufficient to compensate for any time-difference effects in tax collections and expenditures. During this 45-year period, Social Security was on a *pay-as-you-go* basis, with revenues from the payroll tax sufficient to cover current expenditures but not generating a significant surplus.

Then, beginning in about 1987, this situation changed dramatically. In years subsequent to 1987, payroll tax revenues significantly exceeded expenditures and produced annual surpluses that led to accumulation of a significant balances in the OASI and DI trust funds. In fact, by the end of the year 2002, the balance (on paper) in the trust funds was approximately 280% of the expenditures for the following year. This figure, the ratio of thr trust fund balance at the end on one year to the expenses for benefits and administration for the next year is what the Trustees call the *trust fund ratio*.

This remarkable run-up in trust fund balances was predominantly the result of changes passed by Congress and signed into law by President Richard Nixon in 1972. These changes created programmed increases in payroll tax rates for OASI/DI culminating in an employee rate of 6.2% in 1990 as well as automatic cost-of-living-adjustments (COLAs) in both benefits and the taxable wage base.[5] A small additional effect was due to increases in the self-employment tax passed by Congress in 1983 as well as addition of all new federal employees and all non-profit organization employees to the OASDI program.[6]

Far from being bankrupt, with a trust fund ratio of 280% it would appear that right now Social Security is in pretty good shape, at least on paper.

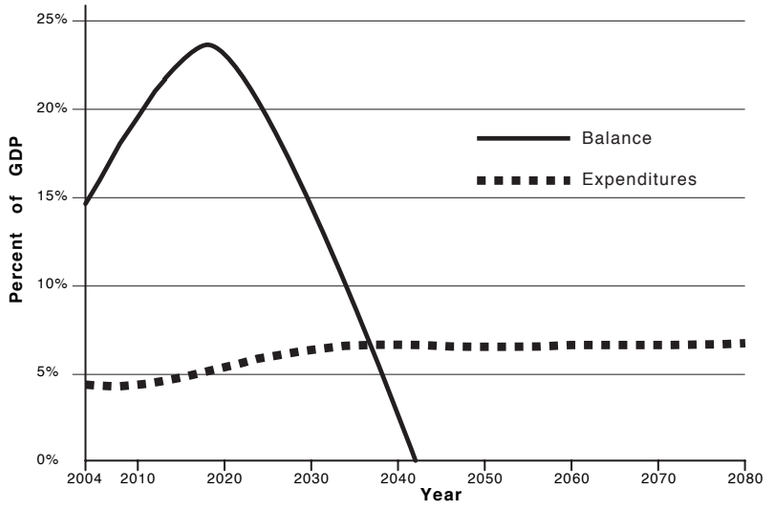
A quick calculation from the last row of Table 3.1: In 2003 income from taxes flowing to the OASDI trust funds was $631.9 billion and expenditures for benefits totaled $479.1 billion, or 75.8 percent of income. This would indicate that in order to exactly cover the expenditures for which they are earmarked, OASDI payroll taxes could be reduced by approximately 24%. This figure is approximate because a portion of the income of the OASDI trust funds is from personal income taxes on Social Security benefits, which are allocated to the fund. These are, however, a relatively minor portion of the income, and so may be safely ignored in approximation. Using the 24% figure, the current OASDI payroll tax rate of 6.2%, or 12.4% for combined employee and employer contributions, could be reduced to 4.7% (9.4% combined), an overall reduction of 3% of qualifying wages, and adequately cover current benefits if Social Security were still a pay-as-you-go system.

In addition to reporting current operations and historical data, the Trustees' Report makes projections into the future. There are two types of projections: short term and long term. Short-term projections attempt to predict events that will occur in the next ten years. Long-term projections attempt to predict situations over the next 75 years.

Without further ado, please note that the best projections of the 2005 Trustees' Report for the next 75 years are summarized by the graphs of Figure 3.2. These represent a combination of short-term projections, for the next ten years through 2013, and long-term projections for the years thereafter. Rather than expressing annual expenditures in billions of dollars as in the historical data, they are expressed as percentages of GDP, which essentially serves to normalize the data for changes in the Consumer Price Index. For reference, it can be seen that the trust fund ratio for the year 2004 expressed in the alternative units corresponds fairly closely to where we left off with actual data for the year 2003.

For the ten-year short-term projections, through the year 2013, the trend is basically a continuation of observed effects in the past ten years of history. Substantial surpluses of income over expenditures continue,

Figure 3.2. Projections, Combined OASI and DI Trust Funds



and these contribute to continuing increase of the trust fund balances and trust fund ratio.

Subsequent to year 2013, however, the long-term projections predict something dramatically different. The change correlates with retirement of the post-WWII baby-boom population bubble. Between 2013 and 2030, this gradually increases the level of expenditures from the OASDI funds from 4.4% of GDP to 6.6% of GDP. After 2030 the level of expenditures remains at the higher level but increases much more slowly. With current law determining payroll tax rates and therefore income, the net effect of the increased expenditures is to reverse the trend of annual surpluses and create a continuing decline in the balance of the OASDI trust funds. The peak of fund balances before the onset of decline is projected to occur in the year 2018. The decline culminates in eventual exhaustion of the funds, estimated to occur in the year 2042.

These projections explain why the years 2018 and 2042 continually appear in current news reports. Additionally, the year 2078 is the last year of the 75-year long-term projection period typically presented in the Trustees' Report for 2004.

And the two-trillion-dollar cost often cited for Social Security privatization? Suppose that starting in the year 2004 the surplus of OASDI income over expenditures was diverted to private investment accounts. That surplus would no longer be available to the U.S. Treasury to use for paying other expenses in exchange for cookie-jar IOUs (special Treasury obligations) credited to the trust funds. In order to fund operations, the Federal Government would have to either find new sources of tax revenue or borrow additional funds from the public to make up the difference. The amount of that difference, from the elevation of the solid line in Figure 3.2 from 2004 to the peak fund balance in 2018 is approximately 9% of GDP. GDP for the year 2018 is projected to be about 22 trillion dollars. The funds unavailable to the treasury due to privatization would therefore be 0.09 times 22 trillion or approximately two trillion dollars. Whether you calculate the cost of privatization at $2 trillion or zero probably depends on how strongly you believe the U.S. Treasury is entitled to receiving those projected surplus OASDI revenues during the next 14 years.

What are the consequences for the federal budget of these predictions?

The surpluses of Social Security revenues over expenditures in recent years have contributed a net inflow to the U.S. Treasury that has reduced the combined amount of taxes and public borrowing necessary for ongoing operation of Federal Government programs. This net inflow is projected to continue until the year 2018. Then there is a dramatic reversal: rather than producing a net inflow, there will be a net outflow. After the balances of the OASDI trust funds pass their peak, it will be necessary each year for the U.S. Treasury to retire a portion of the special securities (cookie-jar IOUs) in the Social Security accounts. Instead of a contribution to the federal budget, Social Security becomes an expense. Instead of reducing the amount of tax collections or public borrowing necessary to sustain federal programs, the need to redeem IOUs will actually increase the amount of tax revenue or public borrowing necessary to sustain government operations.

So, starting in 2018, Social Security in its present form is like a "double whammy" to the U.S. Government budget. Not only has the rich aunt who was helping to support us died. But, beginning immediately, we have to learn to support ourselves 100 percent plus begin paying back all the money our rich aunt gave us.

And not only that! In 2042 it becomes a triple whammy! Once all the money she gave us is paid back, plus interest, we're still obligated to support our auntie's beloved immortal pets – forever!

Now don't you wish we'd never agreed to take her money in the first place?

President George W. Bush has promised to reduce the Federal budget deficit 50% by the end of this decade. An examination of the forward projections of the administration, as reported in the Mid-Session Review of the President's Fiscal 2005 Budget,[7] reveal a dependence on increasing surpluses in OASDI payroll taxes to accomplish this objective.

Although the Social Security Amendments of 1983 stipulated that income and expenditures for OASI and DI should no longer be included in federal budget totals,[8] budget documents from the Office of Management and the Budget (OMB) every year routinely skirt this requirement by reporting *unified-budget* totals that include these amounts. Within the reports, figures not including the OASI and DI numbers are called *on-budget*, while those called *off-budget* are primarily the numbers for OASI and DI reported separately.

Table 3.2 reproduces Table 6 from the 2005 Mid-Session Review. This table shows yearly summary deficit projections for the federal unified budget (figures in bold) decreasing from $445 billion in fiscal 2004 to $229 billion in fiscal 2009, a 48.5% reduction, essentially the 50% promised.

Table 14 of the 2005 Mid-Session Review, a few pages further into the OMB document, presents more detail. Table 3.3 reproduces the administration's Table 14, which clearly shows projections that the on-budget deficit for operations of the U.S. Government will decrease by a lesser amount, from $600 billion in 2004 to $481 billion in 2009. The difference between the on-budget projections and the unified-budget

Table 3.2. Bush Administration Budget Estimates, Totals

From 2005 Mid-Session Review,[7] p. 27, Table 6. BUDGET TOTALS:

	Actual	| Estimates					
Year:	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
In billions of dollars:							
Receipts:	1,782	1,874	2,091	2,239	2,391	2,534	2,665
Outlays:	2,157	2,319	2,423	2,500	2,623	2,762	2,895
Deficit:	**-375**	**-445**	**-331**	**-261**	**-233**	**-228**	**-229**
Gross domestic product (GDP):							
	10,828	11,550	12,221	12,916	13,623	14,364	15,128
As a percent of GDP:							
Receipts:	16.5%	16.2%	17.1%	17.3%	17.5%	17.6%	17.6%
Outlays:	19.9%	20.1%	19.8%	19.4%	19.3%	19.2%	19.1%
Deficit:	-3.5%	-3.8%	-2.7%	-2.0%	-1.7%	-1.6%	-1.5%

projections of Table 3.3 is the off-budget surplus, primarily due to the OASDI trust funds.

The projected decrease in the unified-budget deficit is $216 billion. Increased surpluses in the OASDI accounts are projected to contribute an additional $97 billion to deficit reduction in 2009 vs. 2004, 45% of the total reduction, while decreases in the on-budget operating deficit contribute $119 billion or 55%. Without the contribution of OASDI, the projected deficit reduction, presumably due to increased revenues from general tax sources, would be only 20%.

Other interesting figures in Table 3.3 reveal that Social Security (OASDI) outlays represented approximately 22% of federal unified-budget expenditures in Fiscal 2003. They are projected to remain at approximately 22% through the 2009 fiscal year.

Finally, Table 3.4 contains selected lines from Table 24 of the Mid-Session Review that show the Fiscal 2003 actual and projected yearly totals for the national debt and the portion thereof held by the public vs. that held in government accounts (trust funds). The total national debt is projected to increase from $6.8 trillion at the end of the 2003 fiscal year, to $10.3 trillion at the end of fiscal 2009.

Table 3.3. Bush Administration Budget Estimates, by Category

From 2005 Mid-Session Review,[7] p. 42, Table 14. BUDGET SUMMARY BY CATEGORY:
(In billions of dollars)

	Actual	Estimates					
Year:	2003	2004	2005	2006	2007	2008	2009
Outlays:							
Discretionary:							
Defense (DoD):	388	433	447	420	427	447	467
Homeland security:	24	29	31	32	34	35	37
Non DoD, non-homeland:	413	440	456	448	446	442	439
Total, Discretionary:	825	902	934	899	907	924	943
Mandatory:							
Social Security:	470	491	513	537	564	593	627
Medicare:	246	267	291	345	387	413	441
Medicaid and SCHIP:	165	185	190	201	217	236	256
Other:	29	315	314	304	307	329	336
Total, Mandatory:	1,179	1,258	1,308	1,387	1,474	1,570	1,660
Net interest:	153	159	180	213	243	268	292
Total, Outlays:	2,157	2,319	2,423	2,500	2,623	2,762	2,895
Receipts:	1,782	1,874	2,091	2,239	2,391	2,534	2,665
Deficit:	**-375**	**-445**	**-331**	**-261**	**-233**	**-228**	**-229**
On-budget deficit:	-536	-600	-512	-458	-450	-466	-481
Off-budget surplus:	161	155	180	198	217	237	252

Table 3.4. Bush Administration Budget Estimates, Financing and Debt

From 2005 Mid-Session Review,[7] p. 52, Table 24. FEDERAL GOVERNMENT FINANCING AND DEBT:
(In billions of dollars)

	Actual	Estimates					
Year:	2003	2004	2005	2006	2007	2008	2009
Debt Outstanding, End of Year:							
Gross Federal debt:							
Issued by Treasury:	6,733	7,370	7,990	8,569	9,136	9,716	10,316
By other agencies:	27	27	26	26	26	25	24
Total Federal debt:	6,760	7,397	8,016	8,595	9,162	9,741	10,340
Debt held by:							
Govt. accounts:	2,846	3,067	3,351	3,656	3,971	4,305	4,657
Public:	3,914	4,330	4,665	4,939	5,190	5,436	5,683

A few quick calculations will show that within this total, the portion represented by cookie-jar IOUs (debt held by government accounts) increases from 42% to 45% of the total.

Predicting the future is notoriously risky.

Budget reports of the Office of Management and the Budget only attempt to predict the situation six years out, but historically have been notably unreliable. Many factors influencing the federal budget, national security issues and economic conditions for example, are difficult to forecast even on a six-year time frame.

Short-term projections of OASDI funds, up to ten years, are inherently more reliable, especially on the expense side, because projections depend on population figures and trends that are fairly stable and reliable over the ten year time frame. In attempting to project OASDI expenses and revenues up to 75 years in advance, the Trustees have a more difficult problem. These long-term projections are necessarily less reliable.

Absent clairvoyance, future projections are commonly based on regression analysis. That is to say, it is assumed that values and trends that have been observed in the past will continue into the future in a fairly predictable manner. Where there is doubt, this is often covered as in the OASDI Trustees' Report by making high and low projections to take into account the outlying possibilities as well as an intermediate projection that is thought to be the most probable outcome. The model of Figure 3.2 represents the intermediate, or best-guess, projection of the OASDI Trustees for the next 75 years. There are in the Report, however, also high and low projections that would have the financing situation for OASDI, given current law, far better or far worse than that shown in Figure 3.2.

Ignoring the Contents, Glossary, and Index sections, the 2004 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds comprises fully 189 pages. The first 37 pages contain solid information including a review of operations for the preceding fiscal year, statements of objectives, ten year projections, and summaries of the best-guess scenario for

the longer term, the latter illustrated with some rather confusing graphs. The remaining 152 pages contain historical data plus a lot of baloney. Sliced, diced, and served in a variety of ways, the baloney includes assumptions, and high, low, and intermediate long-term projections in spreadsheets, graphs, actuarial projections, stochastic projections, and explanations of changes from previous projections. All of this illustrates the great beauty of modern computing power, spreadsheets, and modeling software: if you sit a bunch of economists and actuaries down and give them enough time to plug slight variations from historical regression into enough models and spreadsheets, you can produce a pretty impressive report! How many readers will have the patience or stamina to digest all of this is open to question, as is perhaps the value of even trying. If sheer volume produces credibility, then the Trustees have given us that. This would be in a sense similar to the credibility effects of repetitive mantras in the popular press.

In the final analysis, it all amounts to one simple set of statements about the next 75 years: This is our best guess. The long-range projections involve significant uncertainty. Things could be better or things could be worse than we think. We'll have a better guess when time gets closer.

Furthermore, it is important to keep in mind that all of the projections in the Trustees' Report, whether high, low, intermediate, or probabilistic, are based on regression analyses that assume a high degree of stability and absence of revolutionary changes impacting our society and economy. However, as we all should know, revolutionary changes do occur and, in fact, are more likely than unlikely over any long period of time.

Expect the unexpected.

The seventy years since the Social Security system was first instituted in the U.S. have seen great changes in world politics, warfare and weaponry, peacetime military posture, transportation, entertainment, business, electronics, computers, information technology, manufacturing technology, agriculture, biology, and medical science to mention just a few. Some of these might be regarded as revolutionary, and all of them have had some impact on operation of the Social Security system that

would have been difficult to predict 70 years ago. The Trustees' Report makes no mention of such factors.

A few possibilities that might well have significant impact in the next ten to 75 years can be imagined. The possibility of world petroleum production reaching a peak has already been mentioned. A protracted state of war that severely strains our economy and produces changes in our society is another. Developments in human biology and medical science that drastically reduce mortality or eliminate aging are a third. A virulent epidemic that kills or disables vast segments of our population is a fourth. A plague of locusts, mänä from heaven: facetious, but the point being there may be many others that I have not thought of, some positive and some negative. If any one of these were to occur, the future could be much more uncertain than we think.

Summary

- The Social Security trust funds are not now in trouble.
- A $1.5 trillion surplus, sufficient to pay all benefits for 2.8 years, existed in the Social Security trust funds at the end of the year 2003.
- If tax rates are not changed, the surplus in the Social Security trust funds is expected to grow to more than $4 trillion, enough to pay all benefits for 4.5 years, by the year 2018.
- The surplus Social Security payroll taxes are now being used to pay operating expenses of the U.S. Government.
- By borrowing the surplus Social Security taxes, the U.S. Government is able to spend more without raising income taxes or borrowing more from the public.
- The 12.4% Social Security payroll tax could be reduced to 9.4% and still cover current benefit payments.

- With no changes in payroll taxes or benefits, it is expected that the Social Security trust funds will start to be used to pay benefits in 2019 due to retirement of the baby-boom generation. There will no longer be payroll tax surpluses to pay other U.S. Government expenses, and the Government will have to find money to begin paying back what it has borrowed from Social Security. This could be a difficult transition.

- The Social Security trust fund balances are expected to be used up by around the year 2042. The U.S. Government will be obligated to continue paying Social Security benefits. However, payroll taxes will be sufficient to pay only about 70% unless changes in the law are made.

- Long-term projections are very unreliable. The actual situation in 2019 and years beyond could be either significantly better or significantly worse than now predicted.

Chapter 4

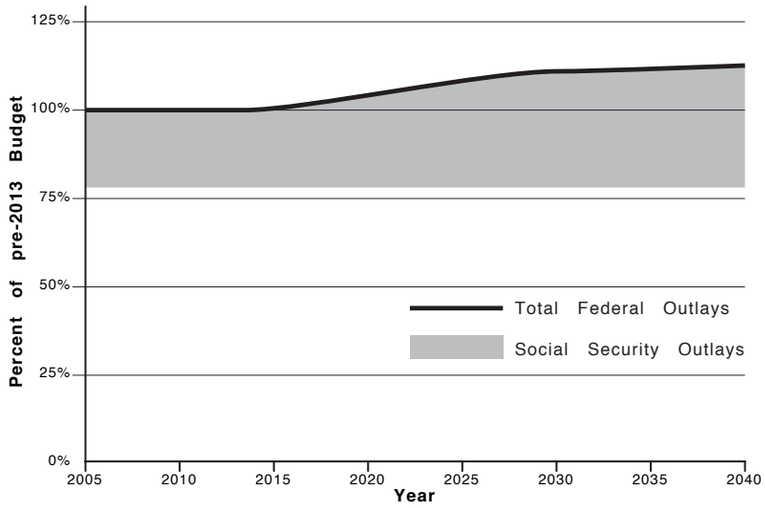
Social Security Finance

Let's look briefly at the projected impact on the federal budget of the baby-boom effect in Social Security benefit payments, expected to occur between the years 2013 and 2030.

From figures shown in Chapter 3 Table 3.3 we see that outlays for Social Security in fiscal years 2003 through 2009 are expected to run consistently at about 22% of total outlays in the federal budget. We can safely assume that pattern to continue until 2013 when the baby-boom effect begins.

Furthermore in Chapter 3 Figure 3.2 we noted that the Trustees of the OASI and DI in their 2004 annual report have projected Social Security outlays to increase from 4.4% of GDP to 6.6% of GDP due to baby-boom retirement. Subsequently, outlays are expected to maintain roughly at that level with relatively minor increases over the following

Figure 4.1. Projected Budget Impact of Baby-Boom Retirement



50 years. Assuming that we normalize all of our projections for GDP, as have the Trustees, this represents a 50% increase in Social Security outlays. Superimposing this 50% increase on the current federal budget composition produces the picture in Figure 4.1. The increase in total federal outlays due to Social Security between 2013 and 2030 is approximately 11%.

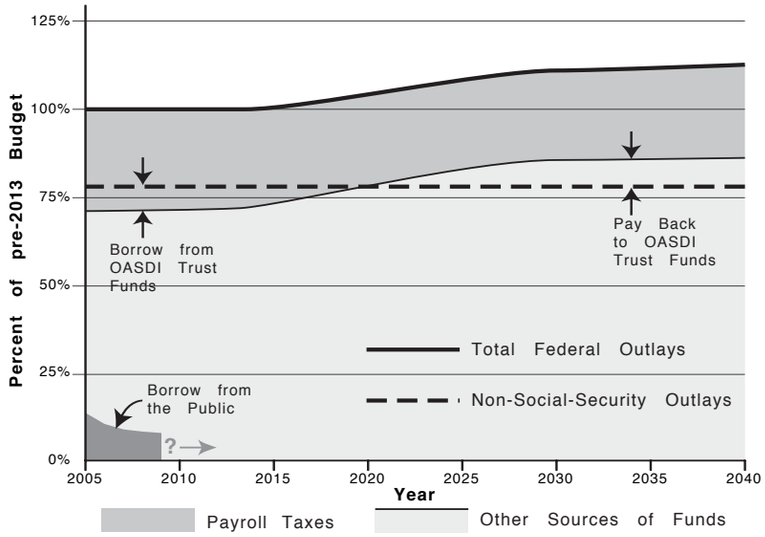
The same increase in total federal outlays is illustrated in Figure 4.2, but this time with emphasis on its implications for Federal Government finance.

In Figure 4.2 it can be seen that under current law the rate of collections from the OASDI payroll tax does not respond to the increase in Social Security outlays between the years 2013 and 2030. In fact, the Trustees in their 2004 Report project a slight decline during that period.[1] Beginning in 2013 and culminating about year 2018, the Federal Government loses the OASDI trust fund surpluses as a source of borrowing to support general government operations. After year 2018, the Federal Government must begin paying back funds previously borrowed from OASDI. The difference between borrowing and paying back OASDI surpluses amounts to a 23% increase in the funds that the Federal Government must obtain from other sources. Possible other sources include taxation and borrowing from the public. The amount projected to be borrowed from the public according to the Bush administration budget projections[2] through the year 2009 are shown in the lower left corner of the figure.

It should be noted that the bulk of the required 23% increase occurs over a period of seventeen years, from 2013 to 2030. The average compound rate of revenue increase required each year to support Social Security during this period is thus only 1.23% (i.e., 101.23% compounded over 17 annual periods equals 123%). Viewed in that light, and assuming a reasonably healthy economy and growth in GDP during that period, the problem does not seem to be a great one.

Another observation is perhaps useful at this point. The amount of additional funding required by the projected increase in OASDI outlays between 2013 and 2030 is actually magnified by the fact that revenues from the earmarked OASDI payroll tax are current-

Figure 4.2. Projected Finance Impact of Baby-Boom Retirement



ly being borrowed to fund other Federal Government expenses. If the current Federal tax structure was adequate to cover non-OASDI expenditures from general revenue sources (clear area below Social Security Outlays in Figure 4.1; dashed line in Figure 4.2), then the percent increase in funding needed between 2013 and 2030 would be only 11%, i.e., the increase in total Federal outlays mentioned in paragraph three, above. Reduced to a compound annual rate of increase over that 17-year period, the need would be only 0.62% – about half as great. Looked at in this way, keeping our financial house in order in the present would certainly be beneficial to our ability to pay projected increases in the future.

The 2004 Trustees' Report directs some attention to the fact that the ratio of the number of OASDI beneficiaries to workers will increase from 3.3 in 2003 to 2.2 in 2030.[3] That is primarily the result of the increased number of baby-boom retirees during that period. This is not a separate problem. It is incorporated in the financial picture presented above. The change in numbers of beneficiaries and wage earners, togeth-

er with increases in the taxable wage base and the fact that payroll taxes currently exceed benefits by the amount of the OASDI surplus, are responsible for the projected changes in payroll tax receipts relative to outlays shown in Figure 4.2.

Proponents of the idea that the Social Security system is in imminent crisis have recently begun citing historical figures, stating that the ratio of the number of beneficiaries per covered worker has declined from 16 in the 1950s to 3.3 today. This value of 16 for the ratio in 1950 was cited by President George W. Bush while promoting the need for Social Security reform in a public meeting at Mellon Auditorium in Washington, DC, on January 11, 2005,[4] and repeated by Dan Bartlett, Counselor to the President, on the NBC news program "Meet the Press" on Sunday, January 16, 2005.[5]

Table 4.1 shows the historical figures for the ratio of beneficiaries per covered worker given in Table IV.B2. of the 2004 Social Security Trustees' Report.[6] It can be seen that the value of 16.5 in the year 1950 occurred at a time when the Social Security system was still in its start-up phase, when increasing numbers of retirees were beginning to qualify for benefits. The ratio declined rapidly through the 1950s and 1960s, reaching a low of 3.2 beneficiaries per covered worker in 1975, and has maintained at a level between 3.2 and 3.4 for the subsequent thirty years, through 2005 for which the projected value is 3.3. It is significant that the surpluses in the Social Security trust funds resulting in a 280% trust fund ratio as shown in Figure 3.1 (Chapter 3) have been built up during this same thirty-year period. This would lead one to believe that for current levels of OASDI payroll tax rates, a ratio of 3.3 workers per retiree has not been a problem from the standpoint of solvency of the Social Security system. In fact, at current payroll tax rates, the $155 billion surplus in OASDI payroll taxes over expenses of $491 billion shown in the President's 2004 budget (Table 3.3 in Chapter 3) permits one to calculate that 3.3 covered workers are actually producing enough revenue to support 1.3 beneficiaries. In other words, current payroll tax revenues would be sufficient to cover expenses if the ratio were only 2.5 covered workers per beneficiary.

Table 4.1. Historical Data, Number of Covered Workers per Beneficiary

	Year	Ratio
Actual	1945	41.9
	1950	16.5
	1955	8.6
	1960	5.1
	1965	4.0
	1970	3.7
	1975	3.2
	1980	3.2
	1985	3.3
	1990	3.4
	1995	3.3
	2000	3.4
Estimated	2005	3.3

The Trustees report that in the year 2078, after exhaustion of trust fund balances, payment of benefits will require a combination of payroll taxes and income taxes on taxable benefits that are credited to OASDI equal to 19% of taxable payroll.[7] The credited income taxes on benefits are estimated at 1%, which would put the requirement for payroll tax at 18% compared to the current combined employee/employer rate of 12.4%. This makes sense if we assume that Social Security will continue to be financed by the present payroll tax structure, but let's also keep in mind that these are best-guess projections for 74 years hence. Seventy-four years is a long time hence!

It is notable that in spite of the fantasy, to be discussed in Chapter 5, that Social Security is supported by a 6.2% tax paid by employees and a 6.2% tax paid by employers, the Trustees' Report refers to "the payroll tax (scheduled to total 12.4 percent)," reflecting reality and not distinguishing between employees and employers.

Another scary number that has begun to appear recently in news coverage of Social Security is $10.4 trillion. It is said that this is the "unfunded promise" of the current Social Security system, i.e., the amount by which payroll tax revenues specified by current law are expected to fall short of future benefits already programmed into the

system. This figure is sometimes abbreviated to $10 trillion dollars by members of the press, and sometimes stretched, for example to $11 million as it was by President Bush in his public meeting at Mellon Auditorium on January 11, 2005.[4]

Where does this $10.4 trillion figure come from?

The 2004 Trustees' Report derives from actuarial projections a total cost in present value for the *unfunded obligation* of the Social Security system over the next 75 years.[8] According to the Trustees' best projections, revenues from payroll taxes first fall short of Social Security outlays in the year 2018. However, payment of benefits is covered by balances in the Trust Funds until 2042, when the Trust Funds are exhausted. At that time the unfunded obligations abruptly begin to appear and continue annually for 35 years, through the end of the 75-year projection period in 2078. The *present value* of these unfunded obligations is the total of the amounts projected for each of the 35 years adjusted for the time value of money, in other words the amount of money we would need to invest now at a projected standard rate of interest in order to generate the amounts needed to cover the shortfalls in the years that they occur. The amount of the unfunded obligation over 75 years projected by the 2004 Trustees' Report is $3.7 trillion.

That's a big number. It is important, however, to remember two things: First, there is no need to come up with $3.7 trillion dollars now in order to assure payment of future benefits, but only in the future years in which the shortfalls occur. Second, the $3.7 trillion impact is spread over 35 years from 2043 to 2078. So the average annual amount of the projected unfunded obligation in each of the years in which they occur is a little more than $100 billion. To put that number in perspective, refer to the Bush Administration figures for Federal Government expenditures in Table 3.3, Chapter 3 of this book. The $100 billion is less than 23% of the $470 billion outlays for Social Security benefits in 2003. Also, $100 billion is less than five percent of the $2157 billion total Federal Government expenditures in 2003. This is not an insignificant amount, to be sure, but note that expressing the amount as a sum total of the requirement over 35 years made it a lot scarier. Also, note that the annual amounts required have already been included in the projected

11% revenue increase required between 2013 and 2030 to cover benefits for baby-boom retirees as deduced from Figure 4.2.

We still haven't answered the question, however, because $3.7 trillion is still a long way from $10.4 billion.

In addition to projecting the unfunded obligation over 75 years, the Trustees' Report goes on to do an interesting thing: It states that because this figure is *only* for 75 years into the future, it may underestimate the total unfunded obligation of the current Social Security system. Accordingly, the Trustees go on to present an actuarial estimate of the unfunded obligation not only for 75 years, but for an *infinite time horizon*. This estimate for an infinite number of years into the future is based on an assumption that the same demographic and economic trends used for making the 75-year projections continue indefinitely into the future. The figure the Trustees come up with for the present value of the additional unfunded obligation after year 2078 on an infinite time horizon is $6.7 trillion. Added to the $3.7 trillion unfunded obligation for the years from present through 2078, this produces the $10.4 trillion figure for the total unfunded obligation on an infinite time horizon.

As noted in Chapter 3, there should be healthy skepticism as to whether the best demographic and economic assumptions of the Trustees' Report will hold for 75 years, let alone eternity. Also, the average human being, as do I, may have some difficulty relating intuitively to financial projections based on an infinite time frame, i.e., eternity. Nonetheless, that is the source of the $10.4 trillion figure.

I would reduce the $10.4 trillion total to an average annual figure, as I have done for the $3.7 trillion unfunded obligation on the 75 year projection, but unfortunately, $10.7 trillion divided by an infinite number of years is zero. That would probably be misleading. The fact that the projected unfunded obligation for an infinite number of years is finite, however, gives hope. It implies that there must be a point out beyond the usual 75-year projection period at which, as long as current demographic and economic trends continue, revenues from Social Security payroll taxes rise to equal benefit expenses. So perhaps the projected funding shortfall is a temporary problem. If we wait long enough, it will go away.

My own guess is that before that happens we will be able to cover the unfunded obligation by payroll taxes on immigrant workers from the planet Zarkon in galaxy 3B7. But I can't prove that.

It is interesting that the $10.4 billion figure for unfunded obligations being bandied about by those making the case that the Social Security system is approaching crisis and in need of immediate reform is possibly the wildest, most far-out estimate in the entire 2004 Trustees' report. It consists of the sum of all projected annual shortfalls in payroll tax revenue based on current law from now until the year "∞" i.e., from here to eternity. I can understand the desire of the Bush administration to make the best case possible for their contention that a crisis is upon us and serious Social Security reforms are necessary. When extreme numbers are taken out of context, however, without adequate explanation of their real meaning, there is a point where advocacy becomes deception.

There is philosophical controversy about the true nature of the U.S. Social Security system. The issues have been discussed in some detail by Shaviro.[9] Is it simply welfare: a system of transfer payments in which recipients are paid benefits from taxes contributed by other taxpayers? Is it an investment plan, in which payroll taxes contributed by wage earners during their working years gain value and come back as payouts during retirement? Is it a risk insurance plan, in which payroll taxes should be regarded as premiums that entitle the worker to compensation for disability and in later years for age and loss in wage-earning capacity? Is it "social insurance," a hybrid term that combines the concept of insurance with benefits to society that justify forced participation and government guarantees?

Let's discuss the questions above briefly in reverse order.

Social Security certainly falls into the category of social insurance. Although historically many government employees and self-employed professionals were exempt, mandatory participation has been extended to include these categories and virtually all wage earners. The currently applicable OASI and DI benefits are guaranteed by the Federal

Government, but not contractually. In fact, the benefit structure of the Social Security system can be altered at any time by act of Congress. Thus the true guarantee that benefits will be delivered as promised is the fact that the current structure is very popular with the voting public. In fact, tampering with Social Security benefits is regarded as extremely high risk politically, which has caused Social Security to be nicknamed "the third rail of American politics."

Strictly speaking, Social Security is not risk insurance. Even though at first glance OASI might appear to be insurance against destitution in old age, benefits are not paid as a function of loss of income. Instead, all participants who meet the minimum requirement for ten years of taxable wages are entitled to receive benefits once they reach retirement age, regardless of whether they remain gainfully employed or have accumulated other assets sufficient for their maintenance. This feature has evolved from a more restrictive rule in earlier years in which benefits were reduced or eliminated for recipients who earned wages above statutory limits. In addition, the level of old age benefits received is determined by contributions during working years, not by need in retirement. Thus recipients who have had higher wages during their working careers are paid higher benefits in retirement, even though they might be expected to have less need, based on having had greater disposable income and opportunity to set aside personal savings, than those with lower lifetime earnings.

Social Security is not an investment plan, although in some ways it behaves like an investment. For example, money deposited by wage earners during their active careers entitles them to receive payments in later years. Unlike an investment, however, the payments are not proportionally related to the amount deposited. There is a redistribution component in the OASI benefit schedules that causes lower wage earners to reap a payout that is higher as a percent of contributions than those with higher wages. There are spousal benefits that favor married over single retirees, out of proportion to contributions. And total payout is a function of longevity, again not dependent on contributions. Finally, other than to a surviving spouse or dependents while underage, there is

no residual value to earned Social Security benefits upon death. Social security does not provide an asset that can be passed to one's heirs.

Social Security does have some features that might be regarded as welfare. Historically, benefits have been funded primarily by taxes paid by current wage earners rather than taxes paid by recipients themselves, which in effect makes the benefits transfer payments. The progressive nature of benefits, with proportionally higher payouts going to those who have made smaller contributions during their working career also might seem welfare-like. However, one must have worked, earned wages, and contributed to the system in order to qualify for benefits. So unlike a simple welfare system, need alone does not qualify one to receive payments.

Thus, while Social Security behaves most like social insurance, it really defies classification into any of these four categories. Instead it embodies features that overlap them all. More important than being able to classify Social Security is that it works, and has done so rather well during its 70-year history. Could this be responsible for its popularity with voters?

A problem, however, is continuing controversy over how the finances of the Social Security system can best be managed. Such controversy is not new, but has existed since the outset. Many of the issues debated during consideration of the original Social Security legislation in 1935 and subsequently in the early years during which the operation of OASI and DI were extended and refined are strikingly familiar

Historically, Social Security has been strongly supported by both Democrats and Republicans. The Social Security system was created in response to the economic disasters that plagued the nation during the Great Depression of the early 1930s. President Franklin D. Roosevelt appointed a Commission on Economic Security to study the matter and propose ways of preventing the same problems from arising again. The Social Security Act passed by Congress in 1935 was based on the Commission's recommendation. The Act became law when signed by Roosevelt on August 14, 1935.

In proposing the legislation to Congress, President Roosevelt stated, "It is a sound idea – a sound ideal. Most of the other advanced countries of the world have already adopted it and their experience affords the knowledge that social insurance can be made a sound and workable project".[10] What Roosevelt proposed was a system of old age pensions that would initially, for current recipients and for the first 30 years or so, be supported by funds provided jointly by the Federal Government and the states. He expected that government funding would eventually be replaced by a system of contributory annuities supported entirely by wage earners – in essence, progressive privatization. Roosevelt strongly advocated creation of the Social Security trust fund and support of the system by earmarked payroll taxes, at least in part to protect the system from being later dismantled. He is quoted as having said, "with those taxes in there, no damn politician can ever scrap my social security program." [11]

Roosevelt also saw Social Security as part of his New Deal program to create jobs. Among the objectives he visualized for federal old age assistance was "to help those who have reached the age of retirement to give up their jobs and thus give to the younger generation greater opportunities for work and to give to all a feeling of security as they look toward old age." [12]

During debate in Congress various alternative proposals were put forward. These included proposals by Democrats to provide more liberal old age and unemployment benefits and proposals by Republicans to eliminate the old age assistance provisions entirely in favor of relying on private charity and the welfare system and to exempt employees covered by private pension plans from participation. In the end these alternatives were rejected, and the Social Security Act was passed by large majorities, 372 to 33 in the House and 77 to 6 in the Senate, including both Republicans and Democrats.[13]

At the signing, President Roosevelt stated, "This law, too, represents a cornerstone in a structure which is being built but is by no means complete. It is a structure intended to lessen the force of possible future depressions. It will act as a protection to future administrations against the necessity of going deeply into debt to furnish relief to the needy. The

law will flatten out the peaks and valleys of inflation and deflation. It is, in short, a law that will take care of human needs and at the same time provide for the United States an economic structure of vastly greater soundness." [14]

The Social Security Act of 1935 called for the program to be supported by a federal payroll tax of 1% on employee wages paid by the employee and an additional 1% paid by the employer. The rates of the payroll tax were programmed to increase in steps and reach 3% each for employee and employer in the year 1949. The tax applied to wages up to a maximum of $3000 per year.[15]

In order to properly understand the context of the time in which this program was created, it is important to know that middle-class wage earners in the 1930s were essentially free from income taxes. The use of income taxes to provide major support for federal programs on an ongoing basis was at that time an incomplete development. Over the previous 140 years since creation of the U.S. Government, federal programs were by current standards relatively few and were supported primarily by tariffs and excise taxes, that is to say taxes on imported goods and taxes on purchased goods, mostly luxury items.[16]

It has been pointed out that major changes in tax law during U.S. history have most often occurred in time of great emergencies, such crises being often the incidence of war.[17] The first income tax was created during the Civil War in order to help pay war costs. It was a flat 3% tax, later revised to a graduated 5% to 10% rate, on incomes of higher wage earners only. Continued for only a few years, that tax was phased out in 1872.[18] The first peacetime attempt to create a federal income tax came in 1894, in response to an economic depression that had decreased foreign trade and tariff revenues. The rate was 2%, and incomes of less than $4000, substantial at that time, were exempt, assuring that only the wealthy would pay. That exercise ended a few months later with a decision by the U.S. Supreme Court declaring the income tax unconstitutional.[19] The constitutional issue was resolved by ratification of the Sixteenth Amendment to the U.S. Constitution in 1913, which specifically allowed income taxes.[20] Shortly thereafter, Congress passed a modest income tax. Again, only the wealthy were subject to the tax. A $3000 personal exemption protected middle-class wage earners. The rate was 1% with a graduated surtax up to 6% on incomes over $20,000. In the first few years of this tax, only about 2% of households were obligated to pay.[21]

The financing of U.S. efforts in World War I provided the impetus for Democrats in the Wilson administration to transform the income tax. The Wilson-sponsored tax program for the first time taxed estates and corporate profits. The personal income tax was expanded and became a highly progressive "soak the rich" program. A corporate "excess profits" tax was implemented and became the largest revenue source.[22] The Republican administrations that succeeded Wilson during the 1920s eliminated the excess profits tax and reduced taxes on corporations and the wealthiest taxpayers. Nonetheless, the income tax was retained.[23]

The Great Depression of the early 1930s was another kind of crisis. In a misguided attempt to stabilize interest rates and encourage investment by reducing the federal deficit, the Republican Hoover administration in 1932 requested, and Congress enacted, the largest peacetime tax increases in U.S. history. In addition to adding sales taxes on gasoline, refrigerators, electricity, and telephone calls, the Hoover tax increases increased personal and corporate income tax rates and reduced exemptions.[24]

The first few years of the New Deal under President Franklin Roosevelt saw only minor adjustments to the income tax. The personal income tax remained highly progressive, essentially a tax on the wealthy. In 1936, income taxes accounted for only $1.4 billion, less than 40% of federal tax collections, and only about two million households out of a total of 32 million owed any income tax. Corporate taxes accounted for over half of income tax collections.[25] This, essentially, was the picture at the time the Social Security System was created in 1935.

The personal income tax might never have become the predominant source of federal revenue that it is today had it not been for the Second World War, during which income taxation was greatly expanded as a means of supporting the war effort and preventing war profiteering. In

1942 President Roosevelt submitted to Congress a seven-point program for keeping the cost of living down in the face of extreme mobilization of the economy for wartime production. His statement of the first point in this program was, "We must, through heavier taxes, keep personal and corporate profits at a low reasonable rate." In a Fireside Chat on April 28, 1942, explaining this program he told the country, "Your income will be subject to higher income taxes. Indeed, in these days, when every available dollar should go to the war effort, I do not think that any American citizen should have a net income in excess of $25,000 per year after payment of taxes." [26]

Congress did not give Roosevelt everything he wanted. But the Revenue Act of 1942 did create a broad-based personal income tax, more highly progressive than at any other time in U.S. history, with rates graduated from 13 percent on the first $2000 to 82 percent on incomes over $200,000.[27] Both the low-income and high-income tax rates were quickly increased from these levels for the remainder of the war. The number of individuals paying income taxes increased from 3.9 million in 1939 to 42.6 million in 1945, and federal income tax collections grew from $2.2 billion to $35.1 billion.[28] The broad-based income tax created during World War II has continued to the present day with the same generally progressive structure, although rates have been adjusted on numerous occasions.

Clearly the intent of the original Social Security legislation in 1935, a time when income taxes were paid by very few Americans, was that the payroll tax would be the primary tax on incomes for wage earners and the personal income tax would remain primarily a tax on the wealthy. From a political standpoint, however, in the absence of any history of income tax obligation, imposition of a new tax paid mainly by low- and middle-income wage earners could have been a very unpopular idea. One can imagine that requiring employers to carry half of the tax burden for a program designed to benefit exclusively workers would have been equally unpopular with business owners. Splitting the tax was probably good politics, however, in that it reduced by half the burden of the new tax on wage earners, by far the more populous group.

Additionally, Roosevelt sold Social Security as an insurance system. In this view, the payroll tax was actually an insurance premium for which the taxpayers received a clearly defined benefit.[29] The public apparently agreed, and Social Security was enacted with little opposition.

The payroll tax was intended to rise to a level that would have exceeded outlays for benefits and created a surplus in the Social Security Trust Fund.* World War II changed that plan. With the public facing the transformation of the federal income tax into a broad-based program to support the war effort, Congress voted seven times during the 1940s to delay the programmed increases in the Social Security payroll tax that had been called out in the original Act. The payroll tax rate for employees and employers was held at 1% until 1950, when it was finally raised to 1.5%, but not the 3% originally planned.[30]

President Roosevelt and others argued for maintaining the increases in the tax rate originally programmed in order to assure long-term solvency of Social Security and also argued that the extra payroll taxes collected would help to finance the war effort. Some in favor of freezing the payroll tax rate suspected that Roosevelt wanted the increases mainly to help finance the war effort and also did not feel justified in supporting collection of an earmarked tax in excess of the expenditures it was designed to cover. As a result of the payroll tax freezes, Social Security became a *pay-as-you-go* program rather than a program funded in advance. It remained on a pay-as-you-go basis until the Social Security Amendments of 1972 created the programmed increases in the payroll tax that caused surpluses to begin to accumulate in the late 1980s. Nonetheless, the program proved its value in providing a baseline level of income security in retirement and in case of disability for the majority of American wage earners.

The Social Security Act was first amended in 1939. Leading up to that action, President Roosevelt expressed his opinion that Social Security should be a living program that would be adjusted occasionally to meet current need, stating, "I am hopeful that on the basis of studies and investigations now under way, the Congress will improve

* The Social Security Trust Fund was limited to OASI at the time. The DI program and trust fund was not created until 1957.

and extend the law. I am also confident that each year will bring further development in Federal and State social security legislation – and that is as it should be." [31] In that same speech, Roosevelt also observed, "The Act does not offer anyone, either individually or collectively, an easy life – nor was it ever intended so to do. None of the sums of money paid out to individuals in assistance or insurance will spell anything approaching abundance. But they will furnish that minimum necessary to keep a foothold; and that is the kind of protection Americans want." Some in Congress preferred seeing any balances in the Trust Fund invested in marketable securities instead of special U.S. Treasury obligations in order to prevent fund balances from being used to pay current government expenses, but an amendment to that effect introduced in the House of Representatives was rejected.[32]

Social Security has been amended many more times in years since. Amendments have extended mandatory participation in the program to additional workers and self-employed individuals and added new benefits. Other amendments have adjusted the payroll tax rates and the maximum covered wage as well as adjusting benefits to compensate for the effects of inflation. These amendments, with the exception of the amendments of 1965 which created the Medicare/Medicaid hospitalization insurance program, have been generously supported by members of both major parties.[33] One might interpret this as indicating that there is broad general agreement with the purpose and objectives of Social Security and consequently mutual interest in assuring the preservation and financial health of the program with benefits more or less as currently provided.

Of some interest is the interplay and development of personal income tax rates and payroll tax rates over the life to date of Social Security. The data in Table 4.2 (on pages 60-61) has been compiled from two sources. The historical personal income tax rate data was selected from reports published in the Statistics of Income (SOI) section of the U.S. Internal Revenue Service web site.[34] Personal exemption and dependent exemption data present in the IRS source tables was not included in Table 4.2. My objective here was to simplify and look primarily at the tax rates. However, it should be noted that while the OASDI payroll tax rates always applied to the first dollar earned and there were no deductions or exemptions for OASDI, the lowest-bracket personal income tax rates for each year applied to adjusted gross income up to the dollar level shown after subtracting exemptions. Above that level, higher rates applied on additional income. In each year, there may have been one or more intermediate brackets, after which the highest-bracket rate shown applied to adjusted gross incomes above the minimum dollar level indicated.

The historical OASDI payroll tax data in Table 4.2 is from the 2004 Social Security Trustees' Report.[35] The values shown are combined rates for employee and employer, i.e., double the employee rate. Somewhat the reverse of the personal income tax, the OASDI rates applied only up to the maximum shown. Wages above these amounts might be regarded as a deduction for which only high wage earners qualified.

Combining the data in one table allows for easier comparisons.

If wading through tabular data does not appeal to you, Figure 4.3 displays the rate data from Table 4.2 in graphical form. Historical

Figure 4.3. Historical US Income Tax Rates, 1913-2003

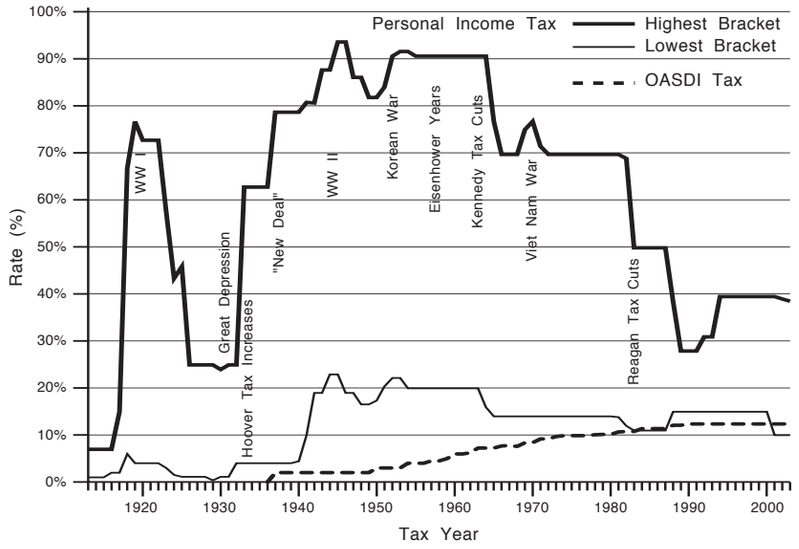


Table 4.2. Personal Income Tax Rates and Combined OASDI Payroll Tax

	Personal Income Tax				Social Security Tax	
	Lowest Bracket		Highest Bracket		Combined OASDI	
Year	Rate(%)	Max($)	Rate(%)	Min($)	Rate(%)	Max($)
1913	1.00	20000	7.00	500000		
1914	1.00	20000	7.00	500000		
1915	1.00	20000	7.00	500000		
1916	2.00	20000	15.00	2000000		
1917	2.00	2000	67.00	2000000		
1918	6.00	4000	77.00	1000000		
1919	4.00	4000	73.00	1000000		
1920	4.00	4000	73.00	1000000		
1921	4.00	4000	73.00	1000000		
1922	4.00	4000	58.00	200000		
1923	3.00	4000	43.50	200000		
1924	1.50	4000	46.00	500000		
1925	1.13	4000	25.00	100000		
1926	1.13	4000	25.00	100000		
1927	1.13	4000	25.00	100000		
1928	1.13	4000	25.00	100000		
1929	0.38	4000	24.00	100000		
1930	1.13	4000	25.00	100000		
1931	1.13	4000	25.00	100000		
1932	4.00	4000	63.00	1000000		
1933	4.00	4000	63.00	1000000		
1934	4.00	4000	63.00	1000000		
1935	4.00	4000	63.00	1000000		
1936	4.00	4000	79.00	5000000		
1937	4.00	4000	79.00	5000000	2.000	3000
1938	4.00	4000	79.00	5000000	2.000	3000
1939	4.00	4000	79.00	5000000	2.000	3000
1940	4.40	4000	81.10	5000000	2.000	3000
1941	10.00	2000	81.00	5000000	2.000	3000
1942	19.00	2000	88.00	200000	2.000	3000
1943	19.00	2000	88.00	200000	2.000	3000
1944	23.00	2000	94.00	200000	2.000	3000
1945	23.00	2000	94.00	200000	2.000	3000
1946	19.00	2000	86.45	200000	2.000	3000
1947	19.00	2000	86.45	200000	2.000	3000
1948	16.60	4000	82.13	400000	2.000	3000
1949	16.60	4000	82.13	400000	2.000	3000
1950	17.40	4000	84.36	400000	3.000	3000
1951	20.40	4000	91.00	400000	3.000	3600
1952	22.20	4000	92.00	400000	3.000	3600
1953	22.20	4000	92.00	400000	3.000	3600
1954	20.00	4000	91.00	400000	4.000	3600
1955	20.00	4000	91.00	400000	4.000	4200
1956	20.00	4000	91.00	400000	4.000	4200
1957	20.00	4000	91.00	400000	4.500	4200
1958	20.00	4000	91.00	400000	4.500	4200

Table 4.2. (continued)

	Personal Income Tax				Social Security Tax	
	Lowest Bracket		Highest Bracket		Combined OASDI	
Year	Rate(%)	Max($)	Rate(%)	Min($)	Rate(%)	Max($)
1959	20.00	4000	91.00	400000	5.000	4800
1960	20.00	4000	91.00	400000	6.000	4800
1961	20.00	4000	91.00	400000	6.000	4800
1962	20.00	4000	91.00	400000	6.250	4800
1963	20.00	4000	91.00	400000	7.250	4800
1964	16.00	1000	77.00	400000	7.250	4800
1965	14.00	1000	70.00	200000	7.250	4800
1966	14.00	1000	70.00	200000	7.700	6600
1967	14.00	1000	70.00	200000	7.800	6600
1968	14.00	1000	75.25	200000	7.600	7800
1969	14.00	1000	77.00	200000	8.400	7800
1970	14.00	1000	71.75	200000	8.400	7800
1971	14.00	1000	70.00	200000	9.200	7800
1972	14.00	1000	70.00	200000	9.200	9000
1973	14.00	1000	70.00	200000	9.700	10800
1974	14.00	1000	70.00	200000	9.900	13200
1975	14.00	1000	70.00	200000	9.900	14100
1976	14.00	1000	70.00	200000	9.900	15300
1977	14.00	3200	70.00	203200	9.900	16500
1978	14.00	3200	70.00	203200	10.100	17700
1979	14.00	3400	70.00	215400	10.160	22900
1980	14.00	3400	70.00	215400	10.160	25900
1981	13.83	3400	69.13	215400	10.700	29700
1982	12.00	3400	50.00	85600	10.800	32400
1983	11.00	3400	50.00	109400	10.800	35700
1984	11.00	3400	50.00	162400	11.400	37800
1985	11.00	3540	50.00	169020	11.400	39600
1986	11.00	3670	50.00	175250	11.400	42000
1987	11.00	3000	38.50	90000	11.400	43800
1988	15.00	29750	28.00	29750	12.120	45000
1989	15.00	30950	28.00	30950	12.120	48000
1990	15.00	32450	28.00	32450	12.400	51300
1991	15.00	34000	31.00	82150	12.400	53400
1992	15.00	35800	31.00	86500	12.400	55500
1993	15.00	36900	39.60	89150	12.400	57600
1994	15.00	38000	39.60	250000	12.400	60600
1995	15.00	39000	39.60	256500	12.400	61200
1996	15.00	40100	39.60	263750	12.400	62700
1997	15.00	41200	39.60	271050	12.400	65400
1998	15.00	42350	39.60	278450	12.400	68400
1999	15.00	43050	39.60	283150	12.400	72600
2000	15.00	43850	39.60	288350	12.400	76200
2001	10.00	12000	39.10	297350	12.400	80400
2002	10.00	12000	38.60	307050	12.400	84900
2003	10.00	12000	38.60	311950	12.400	87000

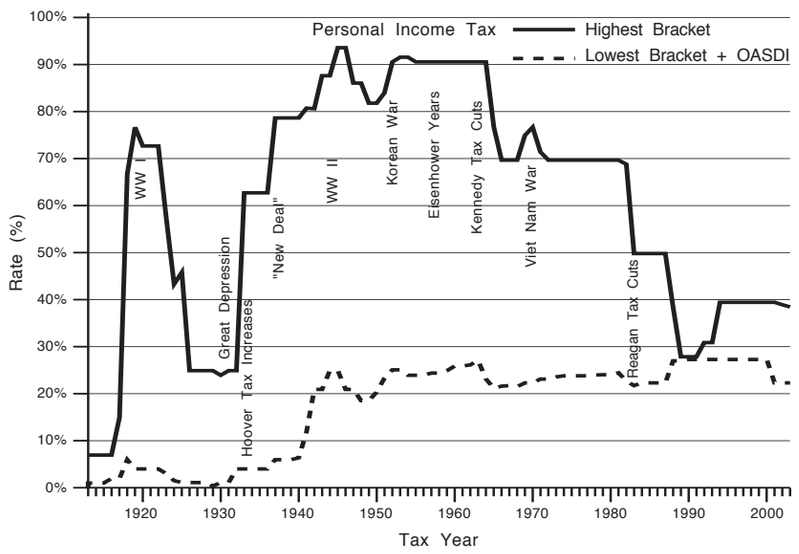
events have been noted on Figure 4.3 at approximate time of their occurrence. The highest-bracket line clearly shows the soak-the-rich tax policy implemented by the Wilson administration in financing World War I and also the tendency for the personal income tax to be primarily a wealth tax in the years before World War II when the lowest-bracket rates were also increased.

Note that the trend in the low-bracket personal income tax rates has since been downward from the highs established during World War II. During the same time, OASDI rates have steadily increased, and the burden of the Social Security tax on lower income wage earners has become at least as great as the personal income tax in recent years. The maximum income to which OASDI tax is applied has also increased dramatically, as can be seen from the last column in Table 4.2. However, those adjustments have been roughly consistent with inflation of wages and the cost of living, so while dollar limits may increase, it is the OASDI tax rate that is more reflective of the economic burden of the OASDI payroll tax.

It should also be mentioned that the hospitalization insurance (HI) tax, which supports Medicare programs, has not been included in the figures of Table 4.2 and Figure 4.3. The combined employee and employer rates for HI has increased from 0.7% at its inception in 1966 to 2.9% in 2003. While the burden of the HI tax is substantially less, the future of federally administered medical insurance is no less important or problematic than OASDI. As previously noted however, I have chosen to treat hospitalization insurance and the healthcare system in general as separate issues, not to be considered in this book. The HI tax, unlike either the personal income tax or OASDI payroll tax, is an entirely flat-rate tax with no exemptions and no income maximum.

Another aside about self-employed wage earners: the so-called self-employment tax is actually the same as OASDI and HI, except that under current law the individual pays both the employee and the employer contribution. The combined rates are the same as shown for OASDI and mentioned for HI. It has not always been that way. When self-employed individuals were brought into the Social Security system by the Social Security Amendments of 1954, the tax rate was set at 75% of the combined OASI rate for wage earners employed by others, and

Figure 4.4. Historical US Income Tax Rates, 1913-2003



similarly for OASDI after disability insurance was added in 1957.[36] The self-employment tax rate for OASDI was raised to 100% of the combined employee-employer rate by the Social Security Amendments of 1983.[37] The self-employment tax for HI was initially 50% of the combined employee-employer HI rate, but also was raised to 100% by the 1983 Act. These increases in self-employment tax rates were offset by tax credits in the remaining years of the decade, but became fully effective in 1990 and years after.[38]

Figure 4.4 combines the lowest-bracket personal income tax rate with the total OASDI payroll tax rate for each year. This combined rate for the lowest wage earners became essentially equal to the highest-bracket personal income tax rate in the years 1989 and 1990. By these rates alone, total wage taxation would appear to have approximated a flat tax in those years. Of course, intermediate brackets actually combined with the OASDI tax to create a "bulge" which caused mid-level wage earners to pay a higher rate. There are, to be sure, other factors such as home mortgage interest deductions and tax shelters, many of which benefit primarily high-

er wage earners, that distort this picture and may actually make the personal income tax system function regressively.

Looking at the tax rate data in Figures 4.3 and 4.4, it is difficult to imagine that Congress and the American public ever tolerated maximum marginal personal income tax rates as high as 93%! However, during World War II that could be understood in the context of sacrifice and all-out contribution to the war effort. Even more amazing is the fact that top marginal personal income tax rates of 90% were allowed to persist through the Eisenhower years and only began to be abated by the Kennedy tax cuts in the early 1960s. Marginal income taxation at that level must have been very frustrating to high wage earners otherwise favored by opportunities to get ahead and achieve wealth in the developing peacetime economy of the 1950s. From personal experience in the early 1980s, I can remember my disappointment when, as an officer of a highly successful small company, I began to receive performance bonuses that put me in a tax bracket approaching the top marginal rate of 50%. My elation in success was always immediately dampened by the realization that California state income taxes on top of high marginal federal income tax rates were leaving me less than fifty cents worth of personal benefit from every extra dollar earned. I can only imagine how it must feel to have the personal benefit of extraordinary efforts and success reduced to less than ten cents on the dollar.

At the same time, it is striking to note how the federal tax burden on the lowest wage earners has continued to rise from extraordinary levels, for that time, tolerated during World War II to even higher levels today. Of course, this has been due primarily to steady increases in Social Security payroll taxes during a period when personal income tax rates on the lowest bracket have actually trended downward. Questions arise. Are these increases tolerated because of an understanding of the value of the Social Security system? Is the public confused by the fact that half of the OASDI tax is attributed to employer contribution, and thereby generally less subject to taxpayer scrutiny? Is the issue further subdued by the fact that both press and politicians seem oddly to avoid much mention of payroll taxes when discussing tax reform? These and other questions will be discussed in more detail in Chapter 5.

Summary

- Future projected shortfalls in Social Security funding are probably less serious than implied by much current hand wringing.
- Future difficulties with Social Security are more evolutionary than catastrophic.
- Terms like “bankruptcy” and “insolvency” exaggerate the problems of Social Security.
- Some numbers cited as showing that Social Security is facing a crisis are deceptive because they have been selected out of context. The alleged 10.4 trillion dollar unfunded obligation is a total projected shortfall for the “infinite” future, and the ratio of 16 workers per Social Security beneficiary in the 1950s was a startup condition, not a steady state.
- Social Security in its current form is a program with a rich history of development and adaptation. It has been supported by both major political parties and is generally regarded as valuable and worth preserving.
- There have been amazing fluctuations in personal income tax rates in the U.S. since the Social Security system was created. These range from confiscatory taxation of earned wealth to a steadily increasing tax burden on the lowest wage earners.
- The true tax burdens on the lowest wage earners are obscured by the division between personal income taxes and payroll taxes, as well as by the attribution of 50% of payroll taxes to employer contribution.

Chapter 5

Wealth and Taxes

The key to accumulating wealth is management. The primary objectives of management in the modern American corporation are maximization of profits and maximization of equity.

There are a few exceptional instances where talent or inventiveness brings great wealth as the result of the labors of one individual – in entertainment, art, and technology. Those are a small, though highly visible, minority.

Creation of wealth involves the creation and marketing of value, production of goods or services that can be exchanged for money, and the means to match products with buyers. In the vast majority of instances that requires management of workers, capital, and technology. Managing capital and technology are often special cases of managing workers. Capital equipment and facilities are built by workers, and new technologies are developed by workers, most often by workers in teams requiring management.

Growing up in the Midwest, son of an engineer who was always most comfortable doing things with his own hands and shunned management responsibility, it took a long time for me to realize this essential reality. I learned to do things for myself and had a knack for science and problem solving that earned me excellent grades in school and a college education. After a truncated stint in graduate school where I became disillusioned with academic life, I moved into a career in sales and marketing in high technology industry. There I learned the importance of selling and promoting products, and also the importance of creating products that served real needs.

Eventually, I found myself working for more than a dozen years as the senior marketing executive in a small company, which grew to be a medium-sized company, owned by a highly successful entrepreneur. An undistinguished scholar a few years older than I and starting with no

more than I had in the beginning, this fellow accumulated a personal fortune of several hundred million dollars by founding, building, and selling several high technology companies. When asked the secret of his success, he would often say, "I didn't like working. I decided if I was going to get rich I would have to get someone else to do the work. The first thing I did after starting my own company was hire other people to do the work." He would also occasionally say, "I hire people who are smarter than I am, then let them do their jobs."

A light was starting to come on in my head. But what could I do? I had been raised and trained to revel in self-sufficiency. I had been lauded for my ability to do things with my hands, to understand things with my brain, to solve problems. I was programmed by my early life and education to be a *worker*. To this day, I feel more comfortable working independently and shrink from the complications of managing others. From the standpoint of becoming truly wealthy, I was doomed. And here I was: being paid, not poorly I'll admit, to work for a man who did virtually nothing for himself, seemed to struggle with understanding even the simplest concepts but fancied himself a technical and marketing genius, bumbled through one naïve mistake after another intermixed with successes, and continually accumulated wealth while those who did the work and much of the thinking that created the wealth were, by comparison, running in place like hamsters.

It is the freedom of idiots. Many of us who are skilled, capable and analytical focus our energy on doing things. We keep busy solving problems, dealing with complexities, and producing while more simple-minded individuals grab power and demand that things be done by others. If successful, it becomes a way of life and the path to wealth. And those who are successful in the path understand best and best reward others who are most like them.

There is a sense of entitlement in those who manage successfully. Once the wealth begins to come, in their minds they are entitled to its continuation, and to more. The company I helped to manage grew consistently in sales and profits for over ten years through the 1980s until the mini-recession of 1990-1992. At that time, sales growth slowed. In recognition of the temporary economic downturn, the management

team was obliged to project, realistically, a year of minimal growth and level profitability, assuming we maintained the organizational structure we had been building to support the growth of the company. The CEO became extremely agitated over these projections. For the first time in ten years, he refused to accept our plan, dictated a layoff that resulted in loss of a number of very competent and contributing employees and crippled the company's ability to grow after the recession ended. It was a time when "downsizing" became a popular concept. Our downsizing, of course, improved short-term profitability and provided affirmation to the CEO of his management ability. Profits grew, even though sales did not. However, the growth in profits still did not equal our historical rate. In justification of the layoffs, which created some unease among retained employees, the CEO began openly lamenting the fact that the company was "losing money," creating even more nervousness among employees. Although profits had actually increased, in his mind he was losing money because the profits the company provided that year did not achieve the historical growth rate to which he had come to feel entitled. Not privy to the financial details, many employees assumed that "losing money" meant the company was operating at a loss and was in danger of financial failure. In reality, the owner was taking many million dollars, in the seven figures, per year to the bank. To add insult to injury, the situation was used to rationalize a second layoff a year later. As a consequence of two layoffs, a number of very capable and competent employees were put out of work and thrown into the job market during a period of recession. It might be worth mentioning that one impact of such layoffs on affected employees is that their AIME (Averaged Indexed Monthly Earnings) is decreased during the job-seeking period, and this tends to reduce monthly Social Security benefit for which they will qualify in retirement. Meanwhile, the profits of the corporation and compensation of the CEO went up.

I wish I could say this sort of action on the part of corporate management is the exception rather than the rule. Unfortunately, that does not appear to be the case. Although corporate profits have always been important, in recent years an increasing emphasis on profits – some would call it greed – to the exclusion of other measures of corporate performance has resulted in massive layoffs, many subsequent to mergers and consolidation. In addition, there is an increasing tendency to limit employee compensation by reducing employer-provided health insurance coverage, retirement benefits, and wages. Wages for a given task are often minimized by hiring younger workers, which can create financial difficulties for older experienced workers who are laid off. The layoff process can be used as a way to skirt age-discrimination and other fair employment rules, which apply to individual terminations but may be waived when mass staff reductions are made for economic reasons. Some of these trends are particularly pronounced in large corporations in the retail marketplace, where many employees work for minimum wage or little more and often without retirement or healthcare benefits. Another tactic is to limit employment hours to part time and hire a larger number of employees than needed in order to skirt statutory benefit requirements for full-time employees. A variation on this theme is to hire and train temporary employees to perform ongoing tasks such as product assembly in manufacturing, then terminate the employment of each group before they become entitled to benefits and job protection afforded permanent employees only to hire and train another temporary group to perform the same tasks later on. Such tactics disproportionately reduce unemployment figures while providing substandard jobs. Those forced to work in such jobs have significant challenges simply providing themselves the necessities of life and little chance of saving for retirement. Admittedly, many corporations operating in highly competitive markets may have little choice if they hope to survive.

Well, OK. Life can be difficult, and there are no guarantees. Except, maybe, Social Security.

Stepping back from anecdotes and analyzing business profits, the objective is adding value. An isolated worker producing goods or performing services can only add a certain amount of value, perhaps enough to get along, but usually not enough to become wealthy. A worker equipped with experience, skills, tools, and publicly available technology can add more value. A worker within a larger organization that provides special tools, proprietary technology, economies of scale,

collective experience, and access to markets can add the most value of all. It is the basis of the gains in productivity that Alan Greenspan frequently talks about. It is the basis for the competitive advantage of larger business organizations in post-industrial society.

As productive small business organizations compete with individuals working independently, and even more productive large business organizations compete with small businesses, it becomes easier for most workers to find employment within the larger organizations. The organizations are able to harness the productivity differential between the individual working independently and within the organization while controlling worker compensation at a competitive level. The difference between worker compensation and the value produced is the return on the capital provided by the organization in the form of tools, technology, experience, and team and scale efficiencies. This difference is generated wealth. When it materializes as corporate profits, it is divided between the owners, i.e., stockholders, of the business and compensation paid to managers. Also, population growth has created mass markets that lead to larger corporations. The larger the organization, and the more profitable, the more wealth accrues. Ergo, the ability of large and profitable organizations to provide extraordinarily high compensation to key executives and to compensate managers at levels significantly above the compensation of mere workers. This is not just a small differential. I used to feel a bit of guilt for earning four or five times the compensation of employees I managed who I knew were talented and working very hard. Key executives in large U.S. corporations are compensated at levels 100-fold and more above the compensation of line employees. The stockholders obtain their share of the generated wealth in the form of dividends and capital gains.

Increased productivity does not always add to corporate profits. For businesses involved in very competitive markets, some or all of the productivity increases may be passed to consumers in the form of discounts and lower prices. When the benefits of increased productivity are passed to consumers, it tends to increase our standard of living, at least to the extent that living standards can be measured in terms of material goods and services. In this case, we may all benefit, so the increased productivity engendered by large organizations is not at all a one-sided proposition. There are some issues related to increasing uniformity and loss of diversity from concentration of products and services in larger nationally based organizations. But that is a cultural issue that will only be mentioned here. It matters to the extent that one values variety and diversity over general material affluence. Also, by virtue of the ability to generate higher differentials between costs and selling prices, the larger corporations may be driving smaller corporations and individuals out of their markets. The power and profits of the larger entities grow at the expense of the independence and potentially higher compensation of workers which would exist in a market where labor has more competitive options.

International outsourcing of labor and services is another case of cost savings that tend to accrue to the benefit of larger corporations. Larger entities are more likely to have the resources for setting up communication and management systems to support these activities. There is a cost to domestic workers and smaller companies, of course, in terms of reduced wages, job opportunities, and ability to compete. The issue is not black and white because there are benefits in reduced costs that may improve our standard of living, and there are benefits to other world economies that may in the long run benefit our own. I mention the matter here only in the context of the social well-being of domestic workers, including items such as retirement sufficiency and healthcare. We would be wise to attempt to maintain such benefits in spite of international labor dislocations and not sacrifice the well-being of our wage earners disproportionately to increased profitability and management compensation.

In societies devoid of large business organizations, the returns on productivity essentially accrue to workers. This, however, is not possible in post-industrial society where the efficiency engendered by larger organizations competes with the lower productivity of independent workers and reduces their earning potential. Increasingly, local units of large retail corporations drive independent stores out of the market and factory farms eclipse family farms. In addition, the objective of most business organizations is to maximize profitability. In view of this, it is

desirable to keep worker compensation as low as practical, and the competitive power of large organizations gives them significant leverage in this regard. By putting independent labor at a competitive disadvantage, the larger organizations are able to dictate to an extent the compensation of the workers who come to them because the alternative of working independently has been made non-viable by competition.

Let it be said that these are all general principles. There is tremendous variation by industry and by company. However, one factor is universal: there is no productivity without workers.

Tools, technology, and experience are meaningless and worthless without the efforts of the workers who make use of them to produce goods and services. Management is impotent without workers. Wealth would not exist without workers, and new wealth would not be generated without workers.

Increasing size and management sophistication in our corporations tends to limit worker compensation at the same time that it increases managerial compensation and corporate profits. Workers compensated at lower levels have a more difficult time providing for their security in retirement, but management has a vested interest in maintaining a happy, cooperative and willingly energetic labor force. As we look for additional sources of revenue to support the Social Security system, it might not be unfair to consider contributions from corporate profits and higher-income wage earners, in the upper management regions, in order to supplement the revenues of the Social Security system.

So who really pays the employer share of the Social Security payroll tax?

The fact that nobody really knows the answer to this question is one of history's great strokes of genius in legislative tax strategy. Just as those who prefer to tax the common man and spare the wealthy would like to convince you that the regressive payroll tax is not a tax at all, but instead a type of insurance premium, so would they hope you will believe that the employer's half of the payroll tax is not paid by you, but a contribution from your employer. And hopefully, when income taxes

are discussed and when tax reforms are implemented, you will forget both of these and look only at the tax that is called *personal income tax*. But, hey! The payroll tax is called the payroll "tax" isn't it? It's not the "payroll insurance premium." Payroll tax. Income tax. Not much difference. A very fine distinction!

Many employers would like to believe the employer portion of the payroll tax is a tax on them. In reality, it is a known and calculable expense of employing each worker, easily taken into account at the time of hiring, part of the total compensation package. Like the employee portion of the payroll tax, the employer portion is proportional to the employee's wage. It is related to each employee on a one-to-one basis. No employers are required to pay the tax for employees who do not work for them. If the employer cannot afford to pay the employer share of the payroll tax in addition to your wages, the employer cannot afford to hire you. The benefit the employer receives from your productivity must exceed your wages plus the employer share of the payroll tax and any other benefits the employer provides in addition to your wages.

There are, however, in the chronology of payroll taxes, a distinct collection of times when the tax really does fall as a burden on the employer. Those are the times when the tax rate is increased. Whenever the payroll tax rate increases, the amount of the increase is an immediate additional cost to the employer. It increases the payroll expense for all *existing* employees, and the employer does not normally have the option of reducing employee wages in order to compensate for this increased expense. Thus, in 1936, when the first 1% payroll tax was imposed, every employer was faced with a 1% increase in total payroll expense, with the exception of that portion of the payroll represented by individual employee compensation greater than the Social Security wage base, then $3000. And during the 1970s and 1980s, as the payroll tax rate was increased in steps from 3.75% to 6.2%, every increase created an immediate increase in payroll expense for employers. As long as the payroll tax rate remains constant, it is predictable and can be factored as a cost of employment for existing employees and when new employees are hired. Whenever the payroll tax rate increases, the employer incurs an immediate increase in payroll expense that is forced

by statute, not incurred by choice. An equal amount of pain, it should be noted, also falls on the employees.

Because the payroll tax is covered by the employment and productivity contribution of the employee, most economists agree that in calculating tax burdens the entire payroll tax should be regarded as a tax on the employee.[1] This view has also been supported by report of the Congressional Budget Office.[2]

There is a method, called an *integrated profit sharing plan*, by which more than half the pain of the payroll tax can be shifted from an employer to its employees. It came as a surprise to me when on one occasion I happened to read the detailed description of my employer's profit sharing plan. How many employees actually read the details of their employer's profit sharing or pension plan?

In contrast to a normal plan, which allocates contributions among employees in proportion to wages, a plan that is *integrated* with Social Security takes into account the wage base on which the OASDI payroll tax is paid and allocates profit sharing or pension plan contributions among employees in a way that discounts out a large part of the employer portion of the payroll tax.

It is difficult or perhaps impossible to find any specific details on integrated profit sharing and retirement plans on either the U.S. Internal Revenue Service web site or the U.S. Department of Labor web site. I tried in vain. However, a Google search on "integrated profit sharing" turned up a number of web sites for consulting companies that advise employers on setting up plans of this type. As an example, I quote the following description from the web site of the Harbridge Consulting Group.

> Integration of Profit Sharing Plans is a process of correlating the benefits or contributions under a Plan with those under a governmental program. Plans may be integrated with various federal and state programs, the most common being federal Social Security benefits. Integration with Social Security is a cost saving method for the Employer under which benefits provided by the Social Security Act are not duplicated. The effect is to maximize contributions made effectively on behalf of higher-paid employees.[3]

The net effect of an integrated plan is that the low-wage employee ends up paying much of the employer payroll tax contribution, not from current funds, but by sacrificing future income from an employer-sponsored retirement plan that disproportionately favors highly compensated managerial employees. The employer recovers much of its share of the payroll tax by providing preferential retirement benefits to officers and key employees. It is somewhat ironic that the purpose of an integrated retirement plan is to reduce retirement benefits for employees in lower wage groups, who might be expected to be most dependent in retirement on the combination of Social Security benefits and the employer-sponsored plan. At the same time, it provides disproportionately larger retirement benefits to the most highly paid employees of the company, who will not only qualify for higher Social Security benefits because of larger career earnings, but should also have had greater ability to provide for their own retirement by saving from their higher disposable income. So, in a sense, some private retirement plans operate like some private health insurance plans, where the objective seems to be to reduce or deny coverage for those who need it most.

I discussed personal income tax rates in Chapter 4 with reference to historical patterns of the highest and lowest rate brackets. Here I want to take a look at the current personal income tax rate brackets in more detail. I'll use data for the 2004 tax year as the example.

Figures 5.1 and 5.2 show graphically the 2004 personal income tax rate brackets for a single taxpayer with no dependents and for a married couple filing jointly with no dependents, respectively. The numbers for constructing these graphs were taken from the instructions for Form 1040 published by the U.S. Internal Revenue Service.[4] For purposes of simplification, the graphs assume a single personal exemption for each taxpayer and use of the standard deduction rather than itemized deductions. Figure 5.2 also assumes that the partners have equal wage and salary income.

In plotting the tax rate brackets against gross income instead of net taxable income, I have shifted the personal income tax rate brackets

Figure 5.1. Filing Single Tax Rates for 2004

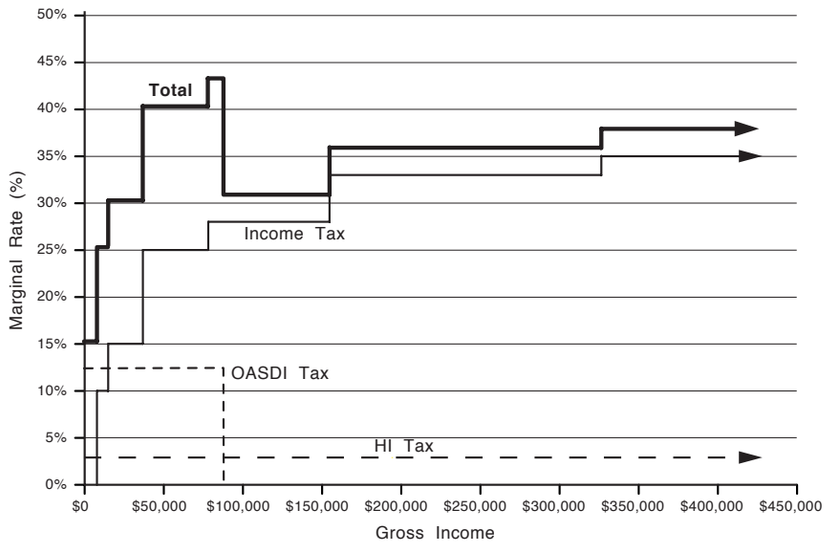
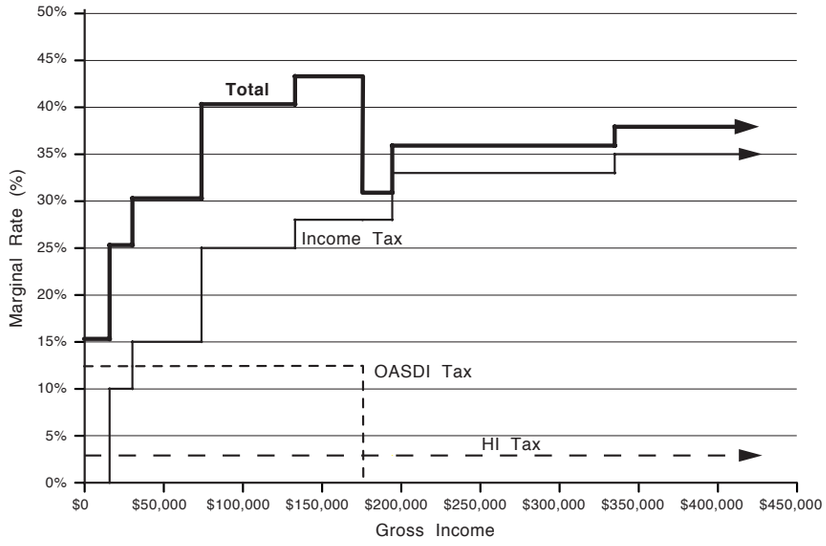


Figure 5.2. Married Filing Jointly Tax Rates for 2004



rightward to create essentially a "zero percent" bracket at the left end of each graph. The width of this zero percent bracket is equal to the sum of the personal exemptions plus the standard deduction. In addition to personal income tax rates, the graphs also show the combined employee-employer rates for the OASDI and HI payroll taxes. Both payroll taxes apply from dollar one of wage and salary income, so there is no zero bracket for the payroll taxes. The OASDI tax rate of 12.4 percent applies up to a limit wage income of $87,500 for the 2004 tax year. Above that limit the OASDI tax rate on addition income is zero percent. The HI (Medicare) tax rate of 2.9 percent applies on all wage and salary income without limit. The arrows at the right end of the traces indicate that taxation at the final rate indicated continues off the chart on larger incomes without limit.

Separate traces in Figures 5.1 and 5.2 show the personal income tax, OASDI, and HI tax rates, as labeled. The top trace (bold line) shows the total marginal tax rate, i.e., the sum of these three taxes, at each value of gross income. Please note that if additional exemptions were to apply, for an elderly taxpayer or married couple with dependent children for example, the zero income tax rate bracket would be widened by the amount of the additional exemptions. However, the overall pattern of the rates would be similar except that the hump due to inclusion of the OASDI tax in the total rates would be imposed at a slightly lower position against the income tax brackets. If the filers chose to itemize deductions, the zero rate bracket would similarly widen and the income tax brackets would similarly shift rightward by the amount of excess of itemized deductions over the standard deduction. Again, the overall pattern would be similar.

The striking effect of including the OASDI payroll tax in computing total tax vs. gross income is that, whereas the personal income tax rates alone appear very progressive, the total tax rates are much less progressive. In fact, above middle income levels, $40,000 to $75,000 for a single filer and $80,000 to $130,000 for a couple filing jointly, the total tax rates are distinctly regressive. A maximum marginal tax rate of 43.3 percent is reached for a single taxpayer at about $80,000 and for a couple filing jointly at about $135,000 of gross income. The marginal tax rate for tax-

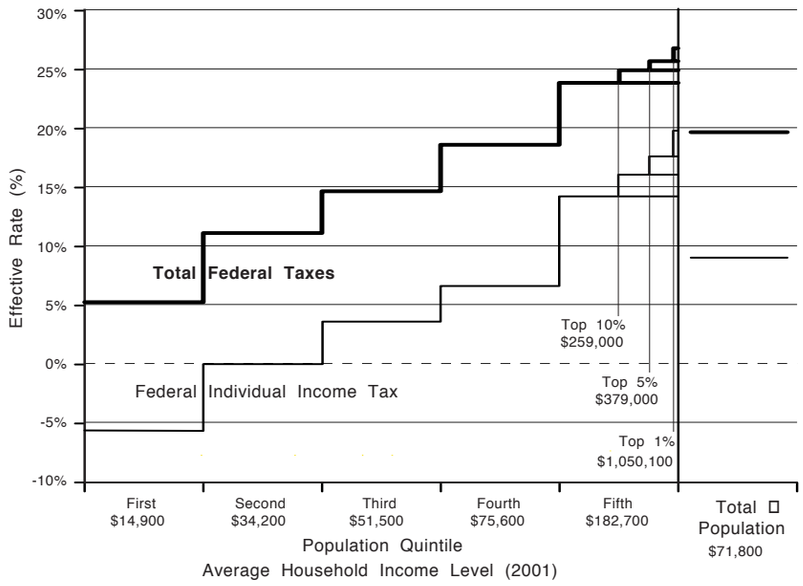
payers with the highest personal incomes (right side of the charts) is 37.9 percent. It should also be noted that these charts include only Federal Government taxes. Taxpayers in states with high state income taxes can easily experience total marginal taxation rates closer to 50 percent in the middle income brackets when state taxes are included in the calculation.

If one takes the region from middle incomes and above, about $40,000 for the single filer and $80,000 for the couple filing jointly, it is fairly easy to visualize a horizontal line, at about 38 percent, that would average out the ups and downs of the total tax rate data. That horizontal line would represent a flat tax for gross incomes above these values.

The rate brackets shown in Figures 5.1 and 5.2 are marginal tax rates, i.e., the rate of taxation that applies to each additional dollar earned at the gross income level shown. Because of the lower rate brackets at the bottom end of the income scale, plus additional deductions and lower tax rates on capital gains, nobody actually pays tax at the highest rates on total income. In addition, at the lowest income levels, and depending on the number of dependents, taxpayers may be eligible for earned income tax credits that can actually result in a net negative tax on income, in effect a subsidy from the Federal Government rather than a tax.

An August, 2004, report of the Congressional Budget Office (CBO) estimated actual tax burdens for total Federal taxation and Federal personal income taxes by quintile of the U.S. population.[5] Each quintile contains an equal number of households, and the quintiles are arranged in order of increasing average household income. The results of these estimates for the 2004 tax year are shown in Figure 5.3. Household income used for these estimates included not just wages but also dividends, interest, capital gains, and stockholders' share of profits on corporate ownership. The average household income for each quintile is shown in the labels for the horizontal axis. In addition to figures for the five quintiles, estimates are shown for the top ten percent, five percent, and one percent of households, and for the overall average of all households.

Figure 5.3. Estimated Effective 2004 Federal Tax Rates



The lower trace in Figure 5.3 shows the estimated burden of personal income taxes only, according to the CBO estimates. The upper trace shows the CBO-estimated total burden of federal taxation, which includes in addition to personal income taxes the OASDI and HI payroll taxes, consumption taxes, for example on cigarettes and alcohol, which impact primarily lower-wage households, and stockholders' share of corporate income taxes, which impacts primarily higher-wage households.

The relevant observation with regard to Figure 5.3 is that the total burden of Federal taxation is significantly lower than might be implied by the marginal personal income tax rates of Figures 5.1 and 5.2. To some extent this is due to the progressiveness of the Federal income tax rate structure, and to deductions that exempt a portion of income from taxation, particularly for middle- and upper-income households.

For the lowest two quintiles the impact of the Earned Income Tax Credit can also be seen. Intended to provide work incentives for citizens who might otherwise be supported by welfare programs, the Earned Income Tax Credit provides payments up to $4300 against Federal tax

obligations for households with wages below about $35,000 per year.[6] These tax credits actually result in net negative personal income tax, essentially a Federal income supplement, for the lowest quintile, and approximately zero personal income tax for the second quintile. That the total effective tax for the lowest quintile is not negative can be attributed to the impact of the Social Security payroll taxes. It would be fair to say that, on average, households in the first quintile not only pay no Federal income tax, but also that their Social Security payroll taxes are subsidized by transfers of income tax revenue from taxpayers in the third, fourth, and fifth quintiles. Households in the second quintile also, on average, pay no Federal income tax, but do pay the major share of their own Social Security payroll taxes.

As a general point of interest, the CBO report also estimated that for 2004 the top 20% of households will contribute a whopping 82.1% of all revenue from individual Federal income taxes and 63.5% of all Federal taxes. These numbers are indicative of the concentration of income in our society.

The estimated effective rates shown in Table 5.3 are based on reported incomes. They are overestimates to the extent that cash compensation of workers in lower quintiles goes unreported – a sort of black-market economy that is known to exist – and to the extent that illegitimate tax shelters and sophisticated tax cheating result in under-reporting of income in the highest quintiles. In both cases, under-reporting is made possible by understaffing, limited resources, and ineffective enforcement by the U.S. Internal Revenue Service.[7]

It has been said that three out of four households now pay more in Social Security taxes than income tax.[8] Looking at the lowest bracket tax rates vs. payroll tax rates in Figures 5.1 and 5.2 and the estimated effective tax rates with and without Social Security taxes for the lowest four quintiles in Figure 5.3, it can be seen how that could be true.

TurboTax® is a registered trademark of Intuit, Inc.

In order to test this assertion and get a better feel for how much typical Americans are actually paying in taxes, I started up my copy of TurboTax® for the 2004 tax year and entered information for four hypothetical households. The results are shown on the next two pages.

Case 1

Shanaya is a single taxpayer with no children or other dependents. In 2004 she earned $20,000 reported on her W2 form as wages from her job as a retail clerk in a bookstore. Her W2 form also reported FICA contributions of $1240 deducted from her wages for OASDI payroll tax and $290 for HI. Doubling these payroll taxes to include her employer's portions, the total OASDI tax paid on Shanaya's wages was $2480 and the total FICA contributions (including both OASDI and HI) were $3060.

Shanaya had no other income and does not own a home. She therefore took the standard deduction in calculating her tax. She owes Federal income tax of $1454 for the 2004 tax year. Her total OASDI contributions of $2480 were significantly more than her income tax.

Shanaya's total compensation, including her employer's share of FICA contributions, was $21530. The total of Shanaya's Federal income and payroll taxes is $4514, representing 21% of her compensation.

Case 2

Tim and April, a young married couple, file their tax return jointly. They have no children or other dependents and do not own a home. They take the standard deduction. In 2004 Tim earned $50,000 as an auto mechanic and April earned $30,000 as a bank teller for a combined income of $80,000. Tim and April had no other sources of income. Their W2 forms reported FICA contributions of $4960 for OASDI and $1160 for HI. Doubling these payroll taxes to include their employers' portions, the total OASDI tax was $9920 and the total FICA (including both OASDI and HI) was $12,240.

Tim and April owe Federal income taxes of $9506 for 2004. Their total OASDI contributions of $9920 were more than their income tax.

Tim and April received total compensation, including the employers' shares of FICA, of $86,120. The total of Tim and April's Federal income and payroll taxes, $21,746, represents 25.2% of total compensation.

Case 3

George and Martha, a married couple, file their tax return jointly. They have three minor children but no other dependents. In 2004 George earned $100,000 as a systems analyst and Martha earned $50,000 managing a local department store for a combined income of $150,000. George and Martha had no other sources of income. Their W2 forms reported FICA contributions of $8525 for OASDI and $2175 for HI. Doubling these payroll taxes to include their employers' portions, the total OASDI tax was $17,050 and the total FICA contributions (including both OASDI and HI) were $21,400.

George and Martha own their home and itemized deductions on their tax return. In 2004 they paid $17,000 in home mortgage interest, $5000 in real-estate taxes, $6,700 in state income taxes, and $600 in deductible vehicle registration fees. They owe Federal income taxes of $18,215 for the 2004. Their OASDI contributions of $17,050 were slightly less than their income tax, but total FICA contributions were greater.

George and Martha received total compensation, including their employers' shares of FICA contributions, of $171,400. The total of George and Martha's Federal income and payroll taxes was $39,615, representing 23.1% of total compensation.

Case 4

Arthur is the corporate attorney for a major U.S. corporation. He is single and has no children or other dependents. He owns a downtown luxury condominium which he occupies as his primary residence. Arthur's W2 form reported salary in 2004 of $500,000. He had no other sources of income. His W2 also reported $5425 in OASDI payroll tax and $7250 in HI. Doubling these amounts to include his employer's contributions, the total OASDI was $10,850 and HI was $14,500.

Arthur itemized his deductions. In 2004 he paid $30,000 in mortgage interest on his condo, real-estate taxes of $15,000, a deductible vehicle registration fee for his Porsche of $1200, and $42,200 in state income taxes. Arthur's Federal income tax for 2004 is $128,719. This is several times higher than his total FICA contributions of $25,350.

Arthur's total compensation, including his employer's share of FICA, was $512,675. The total of his Federal income tax and payroll taxes was $154,069, representing 30% of total compensation.

The examples above support the idea that households with income levels from the first through the fourth population quintiles pay more Social Security tax than Federal income tax. Case 4 shows that a taxpayer in the highest income category pays more Federal income tax than FICA. The high-income taxpayer also pays more total Federal tax as a percent of compensation, at least for earned income, supporting the picture presented by the graphs of Figure 5.3.

For the three example households with lower incomes, total tax as a percent of compensation was fairly consistent over a very wide range of household incomes, from 21% for Shanaya's income of $20,000 to just 23.1% for George and Martha with a household income over seven times higher. Tim and April, with an intermediate income of $80,000 actually paid a higher percentage. This supports the picture presented by Figures 5.1 and 5.2 showing a broad region of relatively flat taxation with perhaps a slight hump in the middle due to the cap on wages subject to the OASDI tax.

Summary

- The vast majority of wealth accumulation results from management of workers, capital, and technology. Wealth creation could not occur without workers.

- Large corporations are often best able to accumulate wealth due to size and productivity advantages compared to independent workers and smaller companies.

- The burden of Social Security payroll taxes, including the employer share, actually falls on the employee, except when the tax rate changes.

- Integrated profit sharing and retirement plans recover a substantial amount of the payroll tax paid by the employer by reducing private plan benefits for low-income employees and providing preferential benefits for highly paid employees.

- Current personal income tax rate brackets are progressive, but the Social Security payroll tax is regressive. When combined, marginal tax rates are flat or slightly regressive above middle-income levels. This means that additional income earned by households in the middle brackets is taxed at a rate equal to or above the rate applied to additional income received by those in the highest brackets.

- Most U.S. wage earners pay more Social Security tax than income tax.

Chapter 6

Social Security vs. Personal Savings Accounts

If the Federal tax structure as it relates to the finance of Social Security seems complex, it pales by comparison to the complexity of calculating retiree benefits. The web site of the Social Security Administration (*www.ssa.gov*) provides no detail. You can enter data into one of several calculators that will estimate your benefits based on your earnings history, and you can request a printed report detailing the benefits to which you are entitled. But nowhere to be found is a complete description of the rules by which your benefits are calculated.

The best explanation of the benefits calculation that I have found appears in Daniel Shaviro's book, *Making Sense of Social Security Reform*.[1] While offering some understanding, Shaviro's explanation of benefits is only slightly less confusing than the extensive philosophical ramblings that populate the rest of his monograph. I'll quote Shaviro's summary statement of the benefit calculation: "Take the PIA on your AIME, adjust for your retirement age and spousal benefits, and then just index it." [2] This is not to denigrate Shaviro's contribution to understanding the issues surrounding Social Security and reform. It is more a lament regarding the incredible complexity of the Social Security system as it is currently organized.

The following summarizes my rudimentary understanding of the benefit calculation in the hope it will provide useful to readers. I have been assisted in this understanding by the information presented in a guide by Epstein.[3]

The PIA (Primary Insurance Amount) is simply the monthly Social Security payment for which you will qualify at your *full retirement age*. If you were born before 1937, your full retirement age is 65 years. If born between 1943 and 1954, it is 66 years. If born after 1959, your full retire-

ment age under current law will be 67 years. For wage earners born in the intervening years between these brackets, the full retirement age increases at a rate of two months for each birth year.[4]

You can retire early, down to age 62, or you can retire later than your full retirement age. If you retire early, your monthly benefit will be reduced. If you delay retirement, your monthly benefit will increase. If you delay retirement past age 70, there is no further increase in your monthly benefit. The term "retire" as used here means to elect to begin receiving Social Security benefits. Under current law, you are no longer required to actually retire in order to receive the full monthly benefit for which you qualify. If you retire early, earnings limits still apply, but restrictions on earnings for benefit recipients who have reached their full retirement age were eliminated in year 2000 by the Senior Citizens Right to Work Act.[5] If you earn more than a threshold amount, a portion of your Social Security benefits will be subject to federal income taxes. You will continue to pay the Social Security payroll tax on earned income.

You must have worked, earned wages, and paid OASDI payroll tax for 40 quarters, i.e., ten years, in order to qualify for any Social Security retirement benefit at all.

Your PIA is calculated based on your average monthly earnings for the best 35 years of your working career. Earnings in other years are excluded from the calculation. Earnings in each of the 35 years are indexed for inflation to calculate your AIME (average indexed monthly earnings). For each year, only earnings within the wage limit for OASDI payroll tax (currently $87,500) are included in the calculation. If your working career includes less than 35 years of earnings, your AIME will be decreased because zero wage amounts for each year short of 35 will be included in the calculation.

The greater your AIME, the greater your monthly benefit (PIA). However, the relation is not proportional. Instead, the benefit calculation is based on a declining rate formula: 90 percent of AIME up to a certain level, 32 percent of AIME up to another level, and then 15 percent of the remaining AIME amount. The result of this calculation is to provide proportionally higher monthly benefits for the lowest wage

earners and proportionally lower benefits relative to qualifying wages for more highly paid individuals. In other words, the benefit calculation is tilted to favor those with lower qualifying wages. This is one of what Shaviro calls the "redistributive" aspects of the current Social Security system.

For married couples, spousal benefits are provided at a level of 50 percent of the primary wage earner benefit, regardless of wage history of the spouse. Even if your spouse has never earned taxable wages, you will still qualify for this benefit. The only requirement is that you have been married to this spouse for at least ten years. This aspect of the benefit calculation favors married couples and favors single-earner couples over two-income couples. It is another redistributive effect of current Social Security law. If your spouse qualifies for a higher benefit based on employment, the higher earned benefit is paid, but the spousal benefit is not.

A divorced spouse to whom you were previously married for at least ten years may qualify to collect a spousal benefit based on your earnings. If your ex-spouse has remarried or if there have been multiple marriages, qualification for spousal benefits becomes more complex.

A surviving spouse is entitled to receive 100 percent of the benefit of the primary wage earner.

Monthly benefits for all retirees are adjusted periodically in proportion to changes in the cost of living (COLAs).

There are other qualifying requirements and calculations for disability benefits, which we need not go into here.

As previously mentioned, there is no contractual obligation for the U.S. Government to provide benefits at these calculated levels for retirees. The benefits are assured instead by good faith and trust. Congress could vote to change the benefits at any time for future retirees, or indeed for present retirees. In the interest of stability and political prudence, it is generally accepted as wise that any changes to the benefit structure should be approached with great caution, and if implemented should be necessary, evolutionary, fair, well understood, and non-arbitrary. That is a minimum requirement for Social Security to provide social security.

Some people do not like the redistributive features of the current Social Security benefit structure, particularly the spousal benefit. However, many people do like these features because they at least partially compensate for difficulties faced in retirement by those with the lowest lifetime earnings and also recognize the contribution of spouses who choose staying at home in preference to working in the marketplace. That is why they were created and why they continue to exist in their present form.

Many considerations in relation to reforms involving privatization of the Social Security system have been discussed by Shaviro.[6] In the absence of a specific proposal, however, it is difficult to know which of these are most relevant. A few general observations, however, can be asserted as valid in any case.

Investments in stocks, bonds, or mutual funds are generally regarded as risky compared to commitments of the U.S. Government. The degree of risk varies, although average rates of return, based on historical performance, are expected to be higher than returns on U.S Treasury obligations and the hypothetical "internal rate of return" of the Social Security system.

President Bush has stated his preference for a system that would allow individuals to "own" their retirement accounts. Ignoring for the moment the issue of how to finance the transition and still pay commitments to current benefits, one issue with regard to individual investment accounts is whether participants are free to specify their own investment vehicles. Given total freedom, we would expect a range of performance around the average return. Some investors will do better than average, possibly much better. However, some investors will do much worse. In fact, some investors may lose rather than gaining. If some of the participants in individual accounts do poorly or even lose on their investment, how does this achieve the objective of the Social Security system to provide a minimum level of income security in retirement?

Would the U.S. government provide a backup assurance of a minimum benefit, regardless of performance of individual accounts? If that

were the case, how can we be sure that the cost of providing that assurance will be any less than the cost of the present Social Security benefit system?

An alternative possibility is that the individual account owners are not free to invest their retirement accounts as they please, but must choose from a limited number of investment choices specified by the government or by private contractors hired by the government to manage these accounts. In this scenario, we must have faith that government agencies or professional investment managers can be trusted to make better decisions than individual investors can make regarding their own assets. It is true that we might expect experienced investors to make better decisions than unsophisticated investors. But keep in mind that there is a wide range of performance even on the part of professional investors, and thus we would expect variation in returns. Is it fair for the government to mandate contributions to investment accounts and then place management of investment decisions in the hands of individuals who may have a range of performance in the returns they obtain for their accounts? Does this not create inequities among taxpayers? And if all investment accounts are pooled in order to realize an equal rate of return, are they really individual investment accounts?

Another issue relates to management fees. The current Social Security Administration is highly efficient in terms of the administrative and management costs imposed on the system. According to the Social Security Administration's Performance and Accountability Report for Fiscal Year 2004,[7] the operating expense for administering $487.6 billion in OASI and DI benefit payments was only $4.8 billion, or 0.98 percent. For Old Age and Survivor's (OASI) separately, the operating expense was only $2.5 billion for $412.5 billion in benefit payments – a mere 0.6%. By this measure, administration of the current Social Security system is one of the most efficient bureaucracies imaginable. In essence, the mission is simple, consisting of keeping records of qualifying wages, calculating benefits, and making payments to retirees and other beneficiaries.

By comparison, the task of managing millions of individual investment accounts is potentially much more complex. In addition, managing

investment accounts is not a capability currently embodied in any U.S. Government agency, and therefore would probably best be entrusted under contract to professional investment managers in the private sector. The use of private-sector firms as part of the Social Security plan would add a profit factor to the management expense that is not present in the current plan where administration is performed by a not-for-profit government agency. Can we truly expect the fees for managing millions of investment accounts that are each small in the value of their assets to be comparable to the current overhead of the Social Security system? Will not increased management fees at least partly defeat the objective of earning a better return on Social Security contributions? Indeed, it has been estimated that administration costs for private investment accounts could run between 9% and 11% on all new contributions to the system.[8]

Finally, there is the issue of whether the Federal government should be in the investment business at all. If individual account holders are free to make their own investment decisions, why is the government involved? Why not simply provide a tax credit equal to funds invested by the taxpayer in a private savings or investment account, up to a certain dollar limit? Unlike the current individual retirement account (IRA) rule, which merely provides a deduction to encourage individual saving for retirement, this could be a dollar-for-dollar credit against Federal income tax. The decision for the taxpayer would be a wash: put the money in an investment account dedicated for retirement, or give it to the government as tax revenue. And unlike the deduction for IRA contributions, which favors higher income taxpayers because of their higher marginal tax rates, a retirement investment tax credit would be equally attractive to low and middle income taxpayers.

It is a curious matter, at the very least, that a conservative Republican administration in Washington has been eager to support the idea of government-mandated individual investment accounts. This from those who generally express in favor of less government control of individuals rather than more rules and government directives, especially in the area of our economic lives.

If the government were to get involved in investment decisions, limiting investment choices or deciding how Social Security accounts should be invested in the private sector, how would we avoid abuses, favoritism and conflicts of interest that might arise from favoring one company or industry over another or one investment manager over another as a function of political considerations or personal benefit to those entrusted with these decisions?

The idea that private investment accounts would improve the finances of the Social Security system appears to be a matter of faith. But is that faith really justified? And would privatization favorably impact the ability of the Social Security system to perform its primary mission of assuring a minimum sustenance in retirement to individuals who have contributed to the U.S. economy as wage earners during their productive careers?

Assuming that private retirement accounts are well invested, and ignoring for the moment the issue of variable performance among investors, what would determine the annual rate of return on these investments? Would not the available return for investors be a function of growth in the U.S. economy, as reflected perhaps in total economic activity, typically measured as GDP, or perhaps popular indicators of stock market performance such as the Dow Jones, NASDAQ, or Standard & Poor's indices? Would there be any reason to suppose that private retirement accounts would, on average, outperform these indices? Clearly, in current practice some investors and mutual funds do succeed in outperforming the market indices and GDP by virtue of wise investment choices and good asset placement. But at the same time, there are many investors who under-perform the indices and a few who are unlucky in their choices and actually lose on their investments. The question I'm posing relates to average performance. In the aggregate, can performance of investment accounts really be expected to exceed growth in GDP or the average growth of value in equity markets?

A further question relates to whether returns on investment accounts would be expected to outpace inflation. What factors in the U.S. economy allow investment returns to outpace inflation? Alan

Greenspan speaks frequently of productivity gains, and that would be one factor that allows American workers to produce more value per unit of labor expended, thereby creating gains in profitability or living standard. Another factor might be improvements in competitiveness of American companies in world markets so that the U.S. economy benefits from increased exports. Or alternatively, if foreign companies outpace American companies growth and competitiveness, perhaps investment accounts would benefit from investment in international equity markets or currency futures. Perhaps investment in developing economies hold better promise for retirees. If U.S. industry should perform so poorly on average that foreign equities become generally preferable to shares of U.S. companies, however, I suspect we will have bigger economic problems than simply funding worker retirement benefits.

It seems that investment performance, as every savvy investor already knows, is conditioned on performance of the U.S. and world economy, and in large measure on the extent to which the U.S. economy is competitive in the world. If we employ our resources wisely and use our brains to develop technologies and foster economic conditions that improve productivity, then GDP and market indices will continue to increase and investments, on average, can outpace inflation. Those conditions have maintained throughout U.S. history and hopefully will continue. In addition, if there is truth in the theories of supply-side economics, conditions for investment and economic growth should be even more favorable now than historically as a result of the Reagan tax cuts in the 1980s.

The same factors that favor investment gains, namely GDP growth, profitability, and growth of wealth as measured by equity values, are the factors that affect the ability of the U.S. Government to raise tax revenues. Assuming that the current Social Security system is maintained and individual investment accounts are not a part of the system, the best projections, as discussed in Chapters 3 and 4, indicate that funding retirement benefits beginning in the year 2013 will require an increasing share of GDP. Thus, in order to support Social Security benefits and

maintain levels of other government programs, the U.S. government would need to increase taxes slightly, on the order of 1.23 percent per year during the period of most rapid increase in outlays between 2013 and 2030, or less than 1.23 percent if measures were taken before that time to reduce dependency on Social Security trust fund surpluses to support other U.S. Government expenses, as noted in Chapter 4. Whether the increased tax revenues would be generated by increasing rates and maintaining the existing payroll tax structure, or through other means, is a subject for discussion. And whether the increases required are actually 1.23 percent or some greater or lesser amount depends on how good the best projections of the 2004 Social Security Trustees' Report turn out to be. However, the fact remains that a healthy and growing U.S. economy would permit the U.S. Government to raise these needed taxes just as assuredly as a growing U.S. economy might allow the aggregate performance of individual investment accounts to outpace inflation.

By this reckoning, the need for devoting increased resources to funding Social Security retirement benefits as a pay-as-you-go system at some future date is not a valid argument in favor of abandoning or even partially altering the current system in favor of individual accounts. The real question is: *to what extent are we willing to maintain the commitment of the U.S. government to provide Social Security benefits in relation to the extent that we may be willing to assume the risk inherent in returns on individual investment accounts?* The former would require modest future tax increases. The latter would involve accepting risk and thereby abandoning to some extent the absolute guarantees provided by Social Security for minimum sufficiency of former wage earners in old age. Some might argue that the latter approach is inconsistent with the objectives of the Social Security system, which is intended to provide security and compensate for the downside risks to which those who require the benefits to survive in retirement have already been exposed in their productive lives. My own opinion would support that argument.

Some proposals for Social Security reform would envision a partial privatization with some degree of maintenance of the existing Social Security structure as a backup system, in order to provide guaranteed minimum benefits should some individual investment outcomes be unfavorable. I would submit that a divided system of this sort is the worst of all possible developments. First, because it continues to depend on community commitment and government funding to guarantee benefits. So what is the reason for changing? Second, because it adds complexity to an already complex system. Complexity has associated costs. Management of the current system has been efficient and annual administration expenses are low. Management overhead for individual investment accounts, as discussed previously, would likely be more expensive and produce a greater burden on participants' accounts. Maintaining both systems would impose the highest administrative expense of all because both U.S. government administration and private investment management fees would be assessed.

Other questions relate to the redistributive aspects of the Social Security system. The tilt of benefit calculation to favor those with the lowest wage histories as well as spousal benefits would seem not to be compatible with individual investment accounts. With individual accounts, the benefit actually realized would be a function of the funds invested in the account and the rate of return on the investment. If the funds invested were purely those arising from payroll taxation of the account owner, there would be no redistribution.

Would we really want to abandon the redistributive features of Social Security? After all, these features were created to fill a perceived need and have been maintained through the 70-year history of the system. In view of this history, one assumes they must have some value and a high degree of popular support.

One way to maintain redistribution would be to credit additional tax revenues to the investment accounts of lower wage earners or married couples, then allow these additional deposits to grow with return on the investments. One difficulty with this approach is that it assumes a

prospective knowledge of the future that may not be justified. Will a low wage earner continue to be a low wage earner? If at the end of the game the low wage earner should become a higher wage earner, were the excess deposits in the early years justified? Should they be deducted from the account? Will a married couple remain married and qualify for spousal benefits in retirement? If they do not, should excess contributions be deducted from the account?

In effect, an advance supplementation of contributions of low wage earners already exists with the present system. As pointed out in Chapter 5, the payroll taxes paid by households in the lowest income quintile can be regarded as supplemented by transfers of funds from income taxes paid by workers in higher wage categories through the mechanism of the Earned Income Tax Credit. So there is a precedent.

Another argument for personal investment accounts sometimes heard is the desire to increase the overall savings rate in the U.S. economy. Shaviro expends quite a bit of text on the subject of national saving.[9] A fact of life, however, is that households in the lowest wage categories do not save because their income is not sufficient to cover current expenses, let alone provide funds to save for the future. By providing the Earned Income Tax Credit we recognize that fact and provide supplemental income to assist those on the low end of the wage scale in maintaining a minimum living standard considered acceptable in our society. It does not make sense to try to force those in low wage categories to save if they can not spare the funds to do so. The result of such compulsion would merely be additional borrowing and indebtedness or a requirement for additional income supplements at taxpayer expense to maintain living standards, both of which are forms of negative saving and would cancel out any economic benefit of the enforced saving.

Programs to increase the savings rate must necessarily focus on higher wage earners with excess disposable income. The Bush administration, and supply-siders in general, have been generous with tax cuts for these higher income categories in order to favor investment and produce economic growth. In reality, those with excess disposable income do

not need much encouragement to save and invest. If you have excess income that you do not spend, you have no choice. You must invest it. Otherwise it stagnates and loses value to inflation. Of course, cutting taxes for the wealthy gives them more disposable income to save and invest. Over the long run, that most likely has a significant effect on capital development and technology development with benefits for the U.S. economy. Whether that produces substantial economic stimulation in the short run is, I think, open to question.

If one actually examines the amount of tax benefit provided in the first years of the Bush II administration, the impact even on the highest wage categories is fairly small, as compared to the massive upper income tax decreases instituted by the Kennedy and Reagan administrations, for example. The 2004 CBO report estimates the impact of income tax reductions, including the alternative minimum tax, in the four tax years from 2001 to 2004 at -1.0%, -1.3%, -1.8%, and –1.9% respectively for the middle quintile of U.S. households.[10] Reductions for the fourth quintile are more or less the same. Reductions for the top, or fifth, quintile are somewhat higher at –0.5%, -2.1%, -3.1%, and –3.9%, but skewed toward the most recent years. For the top ten percent, five percent and one percent of households, reductions are progressively larger. For the top one percent the reductions were –0.3%, -3.8%, -5.0%, and –6.8% respectively.

It strains credibility to believe that tax cuts of these magnitudes have really been responsible for the relatively rapid improvement and growth of the U.S. economy observed in 2003 and 2004. A more likely factor might be the large Federal budget deficits that have been pumping an extra $400 billion or so into the U.S. economy each year in excess of taxes collected.

The concept of net saving as it affects investment and growth of GDP applies to the overall economy and not just selected groups of wage earners. If we give people tax breaks to encourage saving and investment, but then the government borrows a bunch more money and spends it, does that really increase net saving?

A tax cut that is balanced by increased government borrowing to pay current operating expenses does not necessarily result in increased

saving, at least in so far as development of capital and new technology are concerned. The reason for this is that an amount of savings equal to the tax cut now flows into U.S. government securities, and this amount of saving is thus subtracted from the amount available for investment in the private sector. To the extent that government borrowing is used to fund infrastructure and research and development projects, these investments in the U.S. government may have positive effects on future economic growth. To the extent that government borrowing merely funds current operations or non-infrastructure pork-barrel projects, it channels these funds into consumption and delays any real savings until such time as the U.S. government is able to make net reductions in the national debt by redeeming U.S. Treasury bonds and releasing these funds for other uses.

One factor with an impact on saving that we might wish to consider is that constant bombardment of consumers with messages encouraging them to spend freely have become rampant in America. Advertising techniques have become amazingly sophisticated and effective in creating demand over the past half century, often for non-essential items, in large part reflecting the improvement and increasing sophistication of electronic communications media. In addition, businesses around the world have succeeded beyond our wildest dreams in creating really great products, especially in the areas of convenience, play, and entertainment. We are constantly being programmed to want these products and to want more of them. It becomes increasingly difficult in this consumption-oriented environment to convince oneself that it makes sense to sacrifice a bit of fun or convenience today in order to save for a better future. We have been encouraged by our culture to become the “me” generation and the “now” generation. Comparatively few messages encourage consumers to consume a little less and save a little more. A renaissance of the concept that there are worthwhile aspects of quality of life not directly reflected in having the biggest SUV or the fastest sports car or the finest big-screen TV or burning more petroleum rather than walking might have more impact on net savings than tax breaks.

Here's another question for the economists: It seems that it has become increasingly common for corporations, not just in the high-technology sectors but throughout the economy as well, to pay minimal dividends to stockholders and to retain profits for investment in their own R&D, plant, and equipment. If the corporations grow, or at least generate a sufficient level of exuberance, stockholders can obtain a return on their investment in the form of capital gains. Does retention of earnings and internal investment by corporations increase net savings? In recent years, is more net saving occurring internally, within corporations, even as there is less saving by wage earners? What does that portend for the ability of our economy to assure the well-being of individuals as compared to the well-being of corporations? Of course, both are important.

And then there is the matter of that two trillion dollars said to be needed to fund the phase-over from the current Social Security system to a system of individual investment accounts. As will be seen in Chapter 7, my recommendation would be for the government to find the two trillion dollars anyway, and stop relying on the Social Security trust funds to pay for Federal operations. But should we choose to do the individual account thing, that problem does exist.

The question of where the $2 trillion dollars might come from (actually it was posed as a need for $1 trillion to $3 trillion dollars) was addressed by ABC reporter George Stephanopoulos to Senate Majority Leader Dr. Bill Frist (R-Tennessee) during a recent broadcast of ABC's Sunday news program, "This Week".

GEORGE STEPHANOPOULOS
(Off Camera) Yeah, but in the next ten years, if you have the private accounts you put yourself one to three trillion dollars more in the hole.

SENATOR BILL FRIST
Well, what we have is a promise in the future that we have made and that promise is $10.4 trillion, it's called unfunded liability but it's basically something we have promised the next generation and we can't deliver it the way it is structured now so what do you do? One way and I agree with Senator Grassley, we have to have a comprehensive look and solicit ideas from the outside, listen, debate. Talk about. A lot of people making suggestions.

GEORGE STEPHANOPOULOS
(Off Camera) So you agree, benefit cuts and tax increases on the table for the long term?

SENATOR BILL FRIST
Well, well, let me say this, $10.4 trillion out there. We may need to make an investment up front and this came down to your question of a transition if you do the personal accounts, which I'm a great advocate for because it increases savings, increase in investment, that creates jobs. It grows the economy. If we do that, we may have to make an investment here in the next five years, ten years or 15 years. Now, by making that investment up front it may be a trillion dollars.

GEORGE STEPHANOPOULOS
(Off Camera) But where do you get the money for the investment? That's what I'm trying to pin down.

SENATOR BILL FRIST
The same way if you had a mortgage for your home and you wanted to begin to prepay that mortgage. You may have to borrow it. But what it does, that $10.4 trillion liability promise will be cut way down.

GEORGE STEPHANOPOULOS
(Off Camera) Let me just stop you right there. If you borrowed, isn't that like taking your Visa card to prepay your mortgage? You're borrowing more money.

SENATOR BILL FRIST
It is, but your mortgage goes from 10.4 trillion down to eight, seven, six, two. That liability to the future because you investing now and, yes, it's like taking bad medicine, it doesn't taste good but you prevent that disease in the future so it's prevention. It's an investment for the future.[11]

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This should go down in the annals, at least in my mind, as one of the dumbest remarks ever made by a politician on a national news program.

Frist seems to have got it backwards. Perhaps he has little experience with personal finance. Don't most people use the equity in their homes to increase the amount of their home mortgage loans in order to pay off other consumer debt that may be carrying a much higher rate of interest?

Well, to be charitable, it was maybe just a momentary lapse of lucidity.

Realistically, the two trillion dollars would be needed over about a ten year period. That's still a pretty hefty annual bill, but not insurmountable if we develop fiscal discipline. But the two trillion is really just the amount that some in the Federal government are now counting on to delay the day of reckoning in or around the year 2013 when we will have to start paying our way in any case. (Refer to Chapter 4.) Perhaps we should get started sooner rather than later.

Incidentally, there's that $10.4 trillion figure again. It's the *unfunded obligation of Social Security for the infinite future* as projected by the 2004 Trustees' Report. (See Chapter 4.) It's interesting that when the $10.4 trillion is cited by those promoting Social Security reform, the time frame over which it applies is never mentioned. The point of the Trustees' calculation is that, assuming we made no changes in the law related to payroll taxes or benefits and assuming our best current demographic and economic projections were accurate and true forever, if we had $10.4 trillion to invest now at a standard rate of return we could guarantee solvency of the Social Security system for *not just the next 75 years, but for all eternity*. For this to work, however, we would have to pay off the entire mortgage this year. Since $10.4 trillion, or even a significant lump sum payment on principal of, say, $2 trillion, seems to exceed our financial capabilities right now, like most homeowners we might find it easier to make our mortgage payments on a monthly schedule. Think of the U.S. economy as the good job that will allow us to make the payments.

Clearly there are many questions related to the idea of privatizing Social Security and creating individual investment accounts to fund retirement benefits. Most of the answers mediate against that path.

Summary

- Social Security benefit calculations are complicated. They depend on income during working years and redistribute payments from higher wage earners to lower earners and from single earners and two-income families to single-income married couples.

- Investments in stocks, bonds, and mutual funds involve higher risk than government commitments.

- Individual investment accounts would be expected to involve higher administrative expenses than Social Security currently.

- Performance of investments depends on the growth and health of the U.S. economy. So, also, does the ability of the U.S. Government to raise revenues by taxation.

- The redistributive aspects of Social Security would be difficult to duplicate with individual investment accounts.

- Some economists see privatization of Social Security as a way to improve net saving in our economy. However, it is futile to attempt to force saving by households that do not generate sufficient income to meet necessary living expenses.

- There is a little problem of where to find two trillion dollars.

Chapter 7

What Should Be Done

To begin, let's dispose of the privatization option. Changing Social Security to a system of private investment accounts administered by the Federal Government doesn't make sense for reasons have been discussed in Chapter 6.

The Bush administration has floated this possibility, but without providing yet any details of how it might be done. Based on early reaction from Congress and the public, the privatization option at this time does not appear to have much chance of becoming law. But when proposals from President Bush come forth, they certainly should be given detailed and serious consideration.

That being said, let us not underestimate the potential of neoconservative influences in Washington to play havoc with rationality in the administration of national affairs. As noted in Chapter 4, at the inception of the Social Security system, conservative Republicans in Congress opposed the idea of creating a federally administered old age insurance plan in favor of relying on private charities and welfare. Attempts to privatize Social Security must be viewed suspiciously as a possible attempt to turn back the clock and dismantle the system that has served its purpose for 70 years in the name of saving it. Not atypically, there is much deceptive labeling these days in Washington. After all, "The American Jobs Creation Act of 2004," signed by President Bush on October 4, 2004, is legislation that creates $130 billion in corporate tax cuts and $7 billion in cuts to individual income and excise taxes.[1] Well, perhaps this will create jobs. But why not just call it a tax reduction bill?

Also as described in Chapter 4, although originally intended to become paid in advance, Social Security became a pay-as-you-go system

by virtue of votes by Congress on seven occasions during the 1940s to delay programmed increases in the payroll tax rate and limit collections to amounts necessary to pay benefits. There was suspicion that President Roosevelt wanted excess payroll taxes to pay part of the expenses of World War II. In fact, more than suspicions: Roosevelt explicitly favored raising the payroll tax for this purpose. Many in Congress did not feel comfortable with the idea of a tax earmarked for funding old age benefits being used to pay other government expenses.

How times have changed!

Would that our representatives had been that analytical and suspicious of administration motives over the past fifteen years, since the increases in payroll taxes programmed by the Social Security Amendments of 1972 began generating surpluses in the late 1980s. In fiscal year 2004, President Bush could count on a surplus of $155 billion in Social Security payroll taxes to help pay war expenses and reduce the amount of public borrowing necessary to support Federal Government operations, as detailed in Chapter 3. Under current law, those annual surpluses are actually expected to increase during the next few years.

The surplus in the OASDI trust funds has reached over $1.6 trillion dollars – more than enough to pay all Social Security benefits for over 2-1/2 years with no further Social Security revenues. This surplus well exceeds the level of Trust Fund assets necessary as a buffer to compensate for any slight year-to-year deficiencies in revenue, were Social Security still on a pay-as-you-go basis.

These surpluses in Social Security revenue are funded by a regressive tax that is paid on dollar one, with no exemptions or deductions, by all wage earners in the U.S., including the poorest. By generating a surplus that defrays a portion of general Federal Government expenses in addition to the old age and disability benefits for which these revenues were intended, these regressive taxes have made possible personal and corporate income tax cuts that disproportionately benefit taxpayers in the highest income tax brackets. The net effect is to take from the poor and give to the wealthy – a reverse Robin Hood effect. This trend in payroll and income tax programs tends to increase the gap between rich and poor in the United States. It becomes more difficult for wage earn-

ers in lower income categories to improve their financial position just as it becomes easier for citizens with the highest incomes to retain wealth and add to it.

As demonstrated by the parable of Chapter 1 and the detailed discussions in Chapters 3 and 4, building large balances in the Social Security trust funds does nothing to ease the problem of paying for projected future outlays by the Social Security system. In fact, as the yearly surpluses in Social Security payroll taxes become larger, the ability of the U.S. Government to react and fund increased future outlays is actually diminished. Payroll tax surpluses traded for captive U.S. Treasury obligations spoil the Government just as surely as cookie-jar contributions traded for IOUs spoiled the parents. Because of the large payroll tax surpluses, the U.S. Government has become accustomed to funding part of its ongoing operations using "gift" monies that are destined to disappear at the very time in the future that it must develop means for covering increased Social Security expenses. The Government has developed a "lifestyle" that may be beyond its means. It would be far better if the U.S. Government had the discipline to limit its programs and enhance reliable ongoing sources of general revenues to pay for its current operations. Spend less, earn more. This would build a platform of healthy government finance and allow us to deal more easily with future changes.

There has been talk that the Bush administration may want to increase the Social Security payroll tax in order to fund privatization. This would be going in the wrong direction. Quite to the contrary, the OASDI payroll tax should be reduced immediately from 6.2 percent (12.4 percent combined) to 4.7 percent (9.4 percent combined) to cease building surpluses and put Social Security back on its historical pay-as-you-go basis. If this is not done, the wage earning taxpayers of America should take to the streets in outrage. What is being done now with excess collections of Social Security OASDI taxes is exactly what conservatives and liberals alike in Congress voted seven times during the 1940s to prevent. How, in the intervening six decades, have we become so passive and accepting? Is it possible that we are so distracted with toys and entertainment and under-informed by our news media that we

just do not understand, that we have not noticed? Or is it that we have always simply assumed that Social Security was a guarantee – untouchable – that the Trust Funds provided this assurance, while the issues involved in their operation have been too complicated for most of us to understand?

Senator Daniel Patrick Moynihan, who served as a member of the Greenspan Commission in the early 1980s, understood. In 1990, seeing that surpluses in Social Security payroll tax revenues were reducing the overall budget deficit, Senator Moynihan introduced a bill to cut the payroll tax rate and return Social Security to pay-as-you-go status. In addition, he proposed that the payroll tax rate should be scheduled to rise and fall according to benefit expenses in order to maintain that status and prevent excessive surpluses. Moynihan's bill, however, was prevented from reaching the Senate floor by a point of order and consequently never came up for a vote.[2]

The surpluses accumulating in the Social Security Trust Funds have been justified as helping to ensure the long-term viability of the Social Security system. Yet, as the surpluses accumulate, those in power increasingly fret about impending bankruptcy and insolvency. These alarums are keeping us off guard. The IOUs accumulating in the Social Security cookie jar have absolutely no effect on our ability to pay Social Security benefits in future years. They merely represent acknowledgment that the excess revenues, formally earmarked for Social Security, have been used by the U.S. Treasury to pay other expenses. When the benefits come due, we will have to find contemporary sources of revenue to pay them, or adjust them as needed to reduce the expense. Call it paying back the funds borrowed by the U.S. Treasury from the trust funds if you will. The fact remains: contemporary sources of funds in future years will be needed to pay the benefits.

Certainly, if we develop the habit of paying operating expenses of the Federal government from current revenues intended for that purpose rather than relying on borrowing of surplus Social Security funds intended for another, we will be better equipped to find the funds necessary to pay slightly increased expenses in the future. Allowing ourselves to become dependent now on easy and free money that we know will

vanish in the future has made the problem of becoming fiscally responsible doubly difficult. Essentially, we have run our credit cards up to the limit, but we will have no home equity to bail us out.

We need to get tougher in U.S. Government fiscal and tax policies.

Decreasing the OASDI payroll tax to 4.7 percent has another benefit. As mentioned in Chapter 5, the payroll tax, including the employer contribution, is generally regarded as paid by the employee. The exception is when the payroll tax rate changes. Increases in the tax rate produce an immediate increase in personnel costs for all U.S. employers. But tax decreases have just the opposite effect. Reducing the OASDI component of the payroll taxes from 6.2 to 4.7 percent would produce an immediate reduction of payroll expenses for U.S. employers in the amount of nearly 1.5 percent. The only exception is that the percent reduction would be less for workers compensated in excess of the Social Security wage base of $87,500, but these are a small percentage of total payroll in the U.S. Thus a reduction in the payroll tax produces an immediate tax reduction for U.S. corporations. At the same time, it also produces a tax reduction of equal magnitude for U.S. consumers, who for the most part would now have an extra 1.5 percent in their income to spend or save. Not a major windfall, but significant. Self-employed workers would realize an immediate 3.0 percent increase in their income.

These increases, if allowed to stand alone, might be expected to stimulate the economy at least as much as the Bush tax cuts enacted to date.

The tax reductions can not, however, stand alone. Something must be done about the deficit. With reductions in the OASDI payroll tax to pay-as-you-go levels, the Federal budget deficit would be closer to $600 billion than to the $445 billion projected by the Bush administration for year 2004, net of Social Security contributions. (See Chapter 3. Table 3.3.).

Federal spending deficits can be tolerated in difficult times and may be expected, in true Keynesian economic tradition, to have a stimulatory effect on the economy. However, when business conditions pick up, there must be a plan to reduce the deficits and, if possible, to begin to reduce the national debt. Properly managed, the Federal budget should act as a sort of damper to moderate the depth of business cycles: by paying down debt and thus increasing borrowing power during good times, and by borrowing to generate deficits that will stimulate growth when the economy slows. Persistent, chronic borrowing risks upsetting the balance, damaging Federal borrowing power, driving up interest rates, which will interfere with economic growth in good times, and decreasing the ability to react and apply stimulation to the economy in times of slowdown.

In addition to reducing the OASDI payroll tax, measures must be implemented to control the deficit. These would include cost control and perhaps some tax increases.

In part, the current Federal deficit is related to the war in Iraq. A modest income tax increase, especially for upper tax brackets, would not be out of line in these circumstances. Up to the present, nearly every major war fought by the United States has been financed by income taxes imposed on the highest income brackets. We have survived these episodes quite well, and in spite of persistence of these taxes beyond the end of hostilities, the U.S. economy has usually experienced a post-war boom. There is no reason to think the current situation should be an exception. To run up unsupportable deficits instead of implementing needed tax increases in wartime is fiscally irresponsible. A decrease in the OASDI payroll tax is necessary because it rectifies an error, put the Social Security system back on a pay-as-you-go basis, and require fiscal responsibility in the Federal operating budgets. However, fiscal responsibility requires that there must either be belt tightening and expenditure limitations, or there must be a general tax increase to reduce the deficit. The expense of the war should be borne by those who can afford to pay. This means in part middle income taxpayers and in greater part upper income taxpayers, not the poor. This is consistent with past practice throughout U.S. history. If as a nation we truly sup-

port a war effort, we should be willing to support it with our pocketbooks and not just talk, parades and bumper stickers.

This is merely reality. People who ignore reality are often compared to ostriches with their heads in the sand. I heard recently that ostriches never actually do put their heads in the sand. That being the case, I suppose these people might be hard to recognize. They walk proudly, pretend everything is under control, and look and act like other ostriches. But they are wrong.

Assuming the Federal budget is operated on a fiscally responsible basis, how then do we adapt to the increased expense of Social Security benefits as the baby boom generation retires in the years from 2013 to 2030?

This is pretty simple.

First, we look for politically acceptable ways to moderate the benefit expense. Perhaps that can be done by additional modest increases in the full retirement age. People are staying healthy and living longer. In all likelihood this will lead to longer working careers. Measures should be taken to encourage this, including preventing age discrimination in employment and hiring practices. Increasing the full retirement age does not prevent someone from retiring earlier, at age 62 if desired. It just reduces the benefit that can be obtained in early retirement. Perhaps we can also look at the spousal benefit and make some adjustments. Two-income families have become more common, and perhaps this should be encouraged. Alternatively, we may wish to retain the current spousal benefit in recognition of a commitment to traditional family structure. Cost of living adjustments should also be examined to make sure there are no windfalls in the way those are applied.

Secondly, we should look at expanding the OASDI payroll tax to include upper wage categories. The HI tax is currently applied without a wage limit. There are significant arguments for making the wage base for the OASDI tax similarly unlimited. As noted in Chapter 4, most wealth accrues to management but could not grow without the participation of workers. Managers in the upper income categories and investors receive compensation based on their ability to generate profits from the excess of value produced by workers in their organizations over worker compensation. Consequently, it is in the interest of managers and investors in large business organizations to keep labor costs low. This is done by limiting workers' wages and the benefits the company provides to them. Corporations have become increasingly sophisticated in managing these limitations. This, at least in part, has resulted in increased competitiveness of large corporations with a national and international scope, and as a consequence increased compensation of managers. It is not unreasonable that a portion of the excess value provided by workers should be collected in the form of taxes on the wages of managers and the profits of investors in order to help support a social program that provides minimum security in retirement to the workers who made it possible to accumulate the wealth.

Finally, an automatic scheme should be adopted for adjusting the OASDI tax rate to reflect actual annual Social Security benefit requirements. A good way to do this would be to take the benefit expenses incurred each year and use that as a base for adjusting the tax rate in the subsequent year. This would not produce any drastic unanticipated changes in the tax rate because changes in benefit expense are expected to occur gradually, in an evolutionary fashion, not abruptly from year to year. This is true regardless of whether the best estimate of future requirements by the Trustees of the Social Security Trust Funds is close to reality or off the mark. The annual adjustments would compensate for decreases, should they happen to occur, as well as increases in Social Security benefit expenses from year to year.

Yes, the burden of Social Security benefits on taxpayers and the economy is expected to increase somewhat, but the increase will be gradual, understandable, and affordable if we make the commitment to support it. If birth rates remain stable, the OASDI tax rates will eventually stabilize, as is currently expected to happen in the years after 2030. Should birth rates increase, the rates might even decline.

Putting such a plan into effect would assure the long-term viability of Social Security as a valuable social program and would eliminate much of the scary talk currently surrounding what happens to balances in the OASDI trust funds. Shaviro[3] has a humorous terminology for the

psychology surrounding the federal trust fund balances and the IOUs in federal trust fund cookie jars. He calls it "Clown Family accounting." Clown Family accounting refers to the phenomenon that problems can be made to appear or disappear by shifting funds from one set of accounts to another, even though there is no change in the reality of the situation. Such is the case with focusing on balances in the OASDI trust funds. Currently, it appears there are healthy balances. But that is not really true because the trust funds contain only IOUs. We fret about the system going bankrupt and becoming insolvent when the balances decrease and eventually disappear. But the balances weren't real anyway! Just cookie-jar IOUs! Like my hypothetical friends in the parable of Chapter One, the cookie jars don't help us. We have to pay the expenses using the resources we have at the time the expenses occur. The IOUs in the cookie jars are totally irrelevant.

The answer: instead of overhauling or privatizing Social Security, we should be continually improving it. In accordance with FDR's thoughts in his radio address of August 15, 1938, we should expect that the Social Security system will require periodic updates and adjustments. That future projections for Social Security finance do not match precisely the legislated rules from years past should not be cause for hype and hysteria. Our long term vision was not perfect then, and it is not now. But our ability to solve problems on a shorter time scale is pretty good. With considered judgement and periodic planning we can adjust and fine-tune the system. This will keep Social Security working to perform, as it has for seventy years, the valuable service of providing a necessary base-line of well-being in retirement and disability to contributing members of our society.

Social Security is not a Mercedes Benz. It's more like an old reliable pickup truck. It's doing the job it was designed to do. Just drive. Don't junk it. New trucks are expensive. They have problems too: often new ones we can't anticipate. That old familiar, dependable pickup is not perfect. But it can be the best bet for getting us where we need to go. If it's not running quite right, we can tune it up. If it needs repair, we can get it done. Let's be smart mechanics who know how to do the job right. Don't entrust it to anyone who will break it while trying to fix it. Yes, the

cost of fuel to run our truck is going up, but if we keep our other finances healthy and don't run up too much debt, we can afford it.

Finally, having dismissed the privatization option as a replacement for the current Social Security system does not mean we should not take steps to encourage private retirement saving. Ideally, everyone in our society would be self-sufficient and able to save and provide for their own retirement by setting aside a portion of their earnings in earlier years. Unfortunately, we have not reached that state of perfection, and that is why the Social Security system is needed. But the well-being guaranteed by Social Security, as we have implemented it in the United States, is minimal. To live in retirement or disability on the benefits of Social Security alone is difficult. In any way feasible, all wage earners should be encouraged to set aside savings and invest in order to supplement their Social Security benefits even if they can not graduate to the class of those who are sufficiently well off to be independent. This does not, however, require government-administered savings or investment accounts. If we are to have ownership, and if retirement savings accounts are to be called private, then let's really make them private. Let government set the stage and create conditions so that private saving for retirement and increased saving in general are favored and not create a new bureaucracy and more government control of individual finance where less government involvement could do just as well.

Favoring savings should not be done by incurring additional government borrowing. One problem that advocates of retirement savings accounts have with the current pay-as-you-go Social Security system is the fact that an older generation is supported in retirement by benefits paid from taxes assessed on a different, younger generation. There is a feeling that it would be better if each generation could fund its own retirement benefits through saving. The pitch to younger wage earners is that, by supporting private accounts, they might be able to break the cycle of intergenerational transfers. If the funds for establishing retirement savings accounts are borrowed by the government, however, the next generation will find itself paying for the loans, which defeats the purpose of the savings accounts. In view of this, incentives for retirement savings should be funded from current revenues.

A Proposal

Here is a five-point plan that will preserve Social Security for at least the next seventy-five years and beyond and also help to assure the overall health of Federal Government finances. In addition, it improves and builds on Social Security by giving all taxpayers including those at the lowest wage levels incentives to save and invest in their own as well as America's future.

Point 1

Immediately decrease the OASDI payroll tax by 3% from its current level of 12.4% to 9.4% (4.7% each for employer and employee). This will put Social Security back on a pay-as-you-go basis and end the excess regressive taxation of wage earners that has been generating meaningless paper balances (cookie jar IOUs) in the OASDI trust funds.

Point 2

Begin immediately to manage the Federal operating budget by controlling outlays and adjusting general taxation. Stop using excess collections of earmarked taxes and Federal trust fund balances to mask the true size of U.S. Government operating deficits and debt.

Point 3

Establish procedures to review and fine tune OASDI payroll taxes and projected benefit outlays routinely on a revolving five-year forward-looking basis. Fine-tuning adjustments to payroll taxation should attempt to minimize rate changes and focus on extending the OASDI wage base to higher income earners and possibly contributions from corporate profits. Maintain healthy balances in the OASDI trust funds, sufficient to act as a buffer against unexpected shortfalls in the five-year adjusted taxes. The ideal trust fund ratio would be in the neighborhood of 100%, i.e., sufficient to pay benefits for one year, and not the current

280%. The trust fund balances should be allowed to drift toward this new level gradually by programmed redemption of special U.S. Treasury obligations (IOUs) over the next thirty years.

Point 4

Make such long-term adjustments to OASDI benefit structure as are politically feasible in order to manage future expenses. Such adjustment might include programmed increases in the normal retirement age, changes in spousal benefits, and modifications to the COLA formulas for automatic indexing of benefits to cost of living.

Point 5

Develop a plan to encourage retirement saving by low and middle wage earners. This plan should include limited dollar-for-dollar personal income tax credits for contributions to qualifying tax deferred investment accounts, similar to current classic IRA accounts. Tax credits are preferred over tax deductions in order to encourage saving by wage earners in lower marginal income tax brackets, including the youngest ones just entering the labor force, without the bias toward higher income wage earners inherent in the present system of IRA deductions. There are many details that would need to be worked out, including how retirement savings tax credits should interact with Earned Income Tax Credits and how personal income tax brackets might be adjusted to maintain needed revenue for Federal Government operations while at the same time diverting the credited funds into personal retirement accounts, but these are not insurmountable. Participation in this retirement savings plan should be encouraged by Federal information and educational programs but voluntary, not mandatory. Such individual retirement accounts would meet the standard of ownership without creating a new and expensive Federal Government bureaucracy. Systems for managing such accounts with reasonable and competitive fee structures are already in place in many financial institutions including banks, insurance companies, and brokerages.

Afterword

In the time since I wrote the body of *IOUs in the Cookie Jar*, the debate over Social Security reform has intensified. It is clear to me, however, that neither the Bush administration nor the opposition actually "get it." Perhaps after sufficient debate a rational approach will materialize. For the moment, it appears that each side has an agenda that is not necessarily in tune with reality and not necessarily in the interest of future retirees.

The administration, in insisting on setting up investment accounts as an alternative to the current system of guaranteed benefits, risks eviscerating the system that has served Americans well for over seventy years and adding problems for a system that is not currently in crisis. Although encouraging individual investment accounts for retirement in addition to Social Security is a good thing, the system proposed by the administration is a limited approach with highly paternalistic management of investment alternatives and bureaucratic involvement that is not necessary if the accounts are to be truly personal and individual ownership is the objective. In advocating this path, the administration attempts to divide the electorate by assuring those over 55 years of age that there will be no changes that affect them, but creating doubt in the minds of younger workers regarding the ability of Social Security to offer them similar benefits. In fact, both groups have a vested interest in the health of the Social Security system: those over 55 because they should be concerned for the welfare of their children and the next generation, and those under 55 who should understand the realities of Social Security finance and not be misled by exaggerated claims of crisis.

The opposition, on the other hand, seems dedicated to the belief that the balances in the Social Security trust funds have real value, although they are simply IOUs documenting that the U.S. Government has used the contributions from Social Security payroll taxes for other purposes and will have to find alternative sources of revenue to replace the funds when the time comes that they are needed to pay benefits . The danger is that they will favor raising payroll taxes and actually increasing the number of IOUs, rather than the responsible approach of lowering the payroll tax to cover benefits on a pay-as-you-go basis and developing the fiscal discipline of paying ongoing expenses of the Federal Government from sources of taxation that are proper for that purpose.

I have also learned that I am not the first to think of balances in the Social Security trust funds as cookie-jar IOUs. Although my narrative in the parable of Chapter 1 is, I believe, unique, a recent Google search combining the terms "cookie jar" and "IOU" turned up the following website entries from 2004 which promote conclusions similar to my own.

At URL *http://www.cfeps.org/pubs/pn/pn0204/* I found *Policy Note Number 02/04* of the Center for Full Employment and Price Stability, a non-partisan, non-profit website of the University of Missouri at Kansas City. Authored by Professor L. Randall Wray, the analysis of Social Security trust fund balances is remarkably similar to my own, and perhaps more succinct and direct.

At URL *http://moneycentral.msn.com/content/P93622.asp* I found a remarkable November, 2004, article by Bill Fleckenstein at MSN Money that analyzes the idea of privatized retirement accounts and also uses the analogy of cookie-jar IOUs in the context of saving for a college education. Fleckenstein's analysis of the privatization scenario is poignant.

Glossary

AIME (Average Indexed Monthly Earnings) — Used to determine the monthly OASI benefit for which a wage earner qualifies. Earnings on which payroll taxes have been paid are adjusted (indexed) for the increase in average wages since the year when they were earned. The highest 35 years of indexed earnings are selected and averaged to yield the AIME.

Bond — A tradable loan security that guarantees its holder repayment of capital at a future specified date (the maturity date) and a fixed rate of interest.

CBO (Congressional Budget Office) — A Congressional agency, established in 1974, for the purpose of providing Congress with objective, timely, nonpartisan analyses needed for various economic and budget decisions.

CEO (Chief Executive Officer) — A manager with primary legal responsibility for the operations of a business corporation, similar or equivalent in responsibilities to corporate president.

COLA (Cost Of Living Adjustment) — A scheme for adjusting financial values over time to compensate for changes in cost of living.

DI (Disability Insurance) — The component of the U.S. Social Security system, added in 1957, that provides assured income to qualified individuals who are no longer able to work due to injury or health problems.

Dow Jones Index (DJI) — An indicator of stock market performance based on stocks of a representative group of major corporations traded on the New York Stock Exchange.

Face Amount — The amount stated on an insurance policy or a bond, to be paid upon death or maturity.

FDR (Franklin Delano Roosevelt) — 32nd President of the United States, elected four times despite crippling physical disabilities, guided the country through recovery from the Great Depression and victory in World War II, generally regarded as the "father" of Social Security.

FICA (Federal Insurance Contribution Act) — The governing legislation and term used to describe payroll taxes allocated to Social Security and Medicare.

Full Retirement Age — The age at which a retiree qualifies to receive full monthly benefits determined by the Social Security primary insurance amount (PIA).

GDP (Gross Domestic Product) — A measure of the total economic activity of a country in a given year. The total market value of all goods and services produced in a country in a given year, plus the value of exports, minus the value of imports. Includes only goods and services produced within the geographic boundaries regardless of the producer's nationality. Essentially, all goods and services produced by domestic labor, regardless of nationality of employer.

GNP (Gross National Product) — Another measure of the total economic activity of a country in a given year. GNP is GDP plus the income accruing to domestic residents from productive activities abroad, minus the income earned in domestic markets accruing to foreigners abroad. GNP does not include goods and services produced by foreign producers withing the geographic boundaries, but does include goods and services produced by domestic firms operating in foreign countries. Essentially, all goods and services produced by domestic companies, regardless of source of labor.

HI (Hospitalization Insurance) — "Medicare," the national health insurance plan for the elderly, set up by act of Congress in 1965, for which a portion of FICA taxes are allocated.

IRS (Internal Revenue Service) — The U.S. Government agency entrusted with collecting all income and payroll taxes.

Keynesian — Refers to John Maynard Keynes, English economist who, in the early 20th Century, propounded economic theory that advocated government intervention and demand-side management to achieve full employment and stable prices.

Maturation Date — The date at which a bond can be exchanged for its full promised value.

NASDAQ Index — A broad-based indicator of stock market performance including many high-tech and small-capital stocks not yet listed on the New York or other major stock exchange. (NASDAQ is an acronym for National Association of Securities Dealers Automated Quotation system.)

OASDI (Old Age, Survivors, and Disability Insurance) — Basically, Social Security, not including Medicare.

OASI (Old Age and Survivors Insurance) — The original component of Social Security dedicated to providing sufficiency in old age but not disability.

Off-Budget — Refers to operations, including revenues and trust fund balances, of government programs such as Social Security for which earmarked taxes are not to be included in accounting of general Federal operating budgets.

OMB (Office of Management and the Budget) — Part of the Executive Branch of U.S. Government. The agency entrusted with preparing, analyzing, and administering the President's budget.

On-Budget — The main operations budget of the U.S. Government, not including dedicated trust funds and earmarked taxes for special programs such as Social Security.

Pay-As-You-Go — A program for which expenses are paid by funds from tax revenues collected in the same year that the expenses are paid.

PIA (Primary Insurance Amount) — The monthly payment from the Social Security system for which a retiree qualifies upon reaching the full retirement age.

Present Value — The amount which if invested today at a standard rate of interest will grow to produce a required amount at a specified future date.

Redistribution — A return that is not strictly proportional to contribution. Generally refers to a program that produces disproportionate payments to favor contributors on the lower-income side.

SSA (Social Security Administration) — The independent U.S. Government agency entrusted with managing the Social Security system.

Standard & Poors Index — An indicator of stock market performance based on a broad-based sample of stocks of 500 major corporations.

Stochastic — Based on probability calculations.

Trust Fund — An accounting mechanism used for tracking monies dedicated for a specific purpose.

Trust Fund Ratio — The balance in the Social Security Trust Funds divided by the current annual expense for benefits and administration of the Social Security system.

Unfunded Obligation — The amount of future outlays specified by current law which are expected to exceed tax revenues specified by current law.

Unified Budget — A summary budget including both on-budget and off-budget items.

W2 – The standard Internal Revenue form on which employers report to the Federal Government and to each employee the employee's total compensation as well as amounts of income and payroll taxes withheld and paid to the U.S. Treasury for a given tax year.

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Notes

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