Social Security and the Budget

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Almost every investigation of the nation’s long-term budget tells a similar story: the nation is not on a sustainable path. But how closely is that budget story related to Social Security?

Many budget projections start with basic spending data on Social Security, Medicare, and Medicaid, interest costs that arise with increased debt, and everything else—and then calculate future deficits that arise when that spending is compared to revenues. Relative to the projected increases in deficits and spending, the growth in Social Security costs is moderate. Health care cost growth, along with rising interest payments on growing debt, dominate the spending numbers, while revenues fall far short of what is necessary to meet projected total spending under current laws. For instance, Social Security costs are projected to rise by about 2 percentage points of America’s gross domestic product (GDP) from about 2007 to 2030, while health costs rise much more.

Social Security nonetheless plays an important role in the nation’s budget crisis. In the first place, it is the flagship of social welfare policy. Many of government’s other programs, as well as private expectations about when to retire, employer design of pensions, and seniority pay, revolve around such Social Security features as when the system says Americans are “old.”

Put another way, within a couple of decades close to one-third of the adult population will be on Social Security, retiring on average for about one-third of their adult lives, if we remain on our current path. This flagship policy has implications for how the rest of public and private policy evolves.

Second, Social Security as a system unto itself is out of balance. One can use the Social Security actuaries’ trust fund accounting, numbers generated by the Congressional Budget Office, or almost any other accounting scheme, and still reach the same conclusion. Social Security has certain features that essentially require it to grow at a rate somewhat faster than the economy—and faster than the revenues devoted to it. Its growth in the share of the economy is hardly new; it has continued on that path for most of its 70 years of existence. Using standards such as the economic well-being of the old compared to the young, or the share of spending devoted to investment in the future, it is always a valid budget question to ask what share of economic growth and government revenues—regardless of overall financial balance—should continue to be devoted to this program versus others.

Third, an economy must adjust to demographic change; there is no alternative. Unfortunately, “Social Security” is often used as a synonym for this demographic issue, but it is not. Government, in turn, must adapt to the effects that lower birth rates and longer lives have on GDP and employment growth, income tax revenues, Medicare revenues, state revenues, Social Security revenues, and total spending on the elderly as a share of both the economy and the government budget. The changes will be reflected partly in Social Security calculations, but also in such effects as the decline in income taxes when the adult employment rate falls.

Simple arithmetic, therefore, tells us that adjustments must be made in work patterns, saving rates, tax rates, or benefit rates—not just in Social Security, but in other public and private programs as a whole. Adjusting to these demographic issues extends well beyond Social Security, but, again, Social Security is the flagship.

Interestingly, Social Security reform is not really an “elderly” issue—at least not for today’s
elderly. No one expects any reduction in current recipients’ Social Security benefits, except possibly a change in the cost-of-living index that affects how benefits adjust for inflation. And even small benefit increases might be possible for some of them. Paradoxically, other budget reforms are more likely to affect the elderly than is Social Security reform.

Social Security reform as a budget issue is mainly about younger generations, who are expected to have significantly higher benefits on average than the current elderly, but whose taxes are insufficient to support those promised benefits. Fixing Social Security is essentially an issue for today’s middle-age and younger people: do they want to see an increasing portion of government effort and taxes devoted to them when they get old, or would they prefer to set priorities for themselves and their children?

The Budget

Figure 1 provides a typical representation of the threats imposed if we stay on our current budget path. Rising debt relative to GDP is generally unsustainable, and right now we are scheduled to stay on this path through bad times and good. This type of budget threatens our ability to conduct macroeconomic policy and respond to the next recession. (After all, debt-to-GDP needs to fall in good times to be able to rise in bad times.) We are also becoming increasingly dependent on foreign lending. Nations with high debt-to-GDP ratios often succumb to a period of high inflation and stagnation, but even when they don’t, an increasing debt-to-GDP ratio slowly chips away at their fiscal stability and ability to respond to new needs and opportunities.

Social Security’s role in this budget must be placed in context. Social Security taxes have generally risen over time to meet expenses but not enough to cover promised future spending. Most economists and budget experts believe that Social Security as a budget issue revolves not simply around its internal accounting balances and trust funds, but rather how much of the economy it occupies and how much of future growth it absorbs.

CBO’s analysis of President Obama’s 2011 budget submission shows revenues increasing by about $1.2 trillion in 2015 over their level in 2009. This annual increase in revenues results from both normal economic growth and recovery from the recession. Figure 2 shows how much of this

FIGURE 1.  U.S. Federal Debt as a Percentage of GDP, 1800–2040

Source: Based on calculations by the Congressional Budget Office, 2009.

FIGURE 2. How the Increased Revenues from 2009 to 2015 Would Be Spent under the President’s 2011 Budget

Source: C. Eugene Steuerle and Stephanie Rennane, the Urban Institute, 2010. Based on data from the CBO March 2010 Analysis of the President’s Budgetary Proposals for Fiscal Year 2011.
projected revenue growth is devoted to Social Security. Over the six years, annual interest costs would rise by more than $240 billion, health care expenses by more than $200 billion (most of which would occur even with health reform), and Social Security by more than $100 billion. That leaves slightly more than $500 billion of additional revenues left for reducing the deficit, which was approximately $1.4 trillion in 2009.1

Therefore, although Social Security is only a moderate player on the growth curve—at least relative to health and interest cost on the debt—it still gets a “most favored player” status in the budget. In addition, the overall budget remains out of balance, and the president proposes to reduce spending on other program categories in aggregate to achieve further deficit reduction and avoid even higher levels of growth in the debt relative to GDP.

**Social Security as Flagship**

Social Security policy is not solely or even mainly about Social Security itself. Social Security is the largest and most recognized part of the social welfare structure in the United States. Many other policies, public and private, revolve around that structure:

- Medicare’s eligibility age has been set largely by equalizing it to what was the “normal” retirement age in Social Security, and there is a fair amount of evidence that Medicare encourages people to retire earlier;
- Medicare’s tax structure for hospital insurance (HI) is a simple add-on to the Old Age, Survivors, and Disability Insurance (OASDI) tax structure;
- government retirement policies for age of withdrawals from private retirement plans (e.g., earliest withdrawal from individual retirement accounts at age 59.5) are closely related to Social Security retirement age;
- private retirement plans often determine payment rates and other policies (such as early retirement provisions) by retirement expectations largely set by Social Security;
- seniority pay schemes among private employers have often been set with the notion that people would retire at or near the Social Security retirement age; and
- perhaps most important, the retirement age in Social Security profoundly affects the revenues government collects outside Social Security. We will discuss this further below under the section on demographics.

In addition, many budget experts believe that although growth in Social Security costs pales in comparison to projected growth in health costs, it can lead efforts for getting the budget under control just as it did in other reforms of the social welfare state. Some also believe that elected officials will not pursue further efforts to control health costs soon after recently passing the health reform bill, leaving Social Security as the largest automatic growth item in the budget that might be addressed in the near term. These observations do not represent a conservative or liberal slant on the issue, much less an economic consideration of whether Social Security reform is, say, more important than further health reform. They merely recognize that Social Security reform can be highly symbolic of the nation’s willingness to reform its overall budget problems.

Some suggest as well that an early victory in achieving Social Security reform would be a welcome signal to foreign creditors, whose power over the economy grows every year.

The flagship is still the largest vessel, even if no longer the swiftest, in the fleet. Other ships still take their signals from it and accommodate its movements.

**Social Security’s Balances and Sources of Growth**

Figure 3 shows Social Security balances over its past and its projected future—excluding the full impact of the recession, which lowers incomes and raises spending, at least temporarily. As can be seen, it is and always has been largely a pay-as-you-go system; what comes in as income goes out as expenses. From the early 1980s until some point in the second decade of the 21st century,
income exceeds expenses, creating some trust fund balances. Then the reverse occurs for all succeeding years.

Note in the graph that the rise to a higher level of benefit payment essentially takes place over the period that the baby boomers retire—from about 2008 to 2030. Thereafter, assuming a fairly level birth rate, costs level out at about the same percentage of GDP.

Some believe that interest costs earned on the excess of income over spending (and deposited in the Social Security trust fund) during this brief period should be treated as available for paying benefits. That means that the income curve (now including interest) in the graph above would at first rise—exceeding expenses until about 2022. Without interest, the expenses curve is expected to exceed the income curve for the first time in 2010.2 But if interest can be credited to Social Security out of the surpluses deposited to its trust fund, then consistency requires that interest costs be attributed to it when it runs deficits—and the income curve in the above graph then falls much more steeply.

From an economy-wide perspective, it is the cost of Social Security that strains the economy. Those costs must be paid—whether with Social Security taxes, or income taxes paid over to Social Security to cover interest costs on its bonds and Social Security’s cashing out of those bonds, or income taxes paid to cover benefits even when there are no trust funds left.

Social Security places these increased demands on the economy for several reasons. First, several legislative reforms increased benefits. Second, from the early 1970s onward, Social Security laws have required that benefits be indexed to wage growth; the formula since 1977 essentially dictates that if members of one generation earn 30 percent more than their parents, then they will receive a 30 percent larger annual benefit.3 Third, life expectancy has expanded significantly since Social Security was established, increasing the expected number of retirement years that the system finances. Combined, these various increases—past benefit enhancements followed by wage indexing of future benefits and longer retirements—have increased lifetime Social Security benefits for a typical couple from about $250,000 in 1960 to over $500,000 in 2010 and, under current law, to over $670,000 in 2035 (figure 4).
Demographics, Middle-Age Retirement, and Their Effect on the Budget

Although many reforms might be made in Social Security, the current impetus for reform is largely driven by imbalances due to demographics. In cash flow terms, the retirement of the baby boom population—though long expected—now leads annually to significant changes in benefits and taxes from 2008 to 2030. Indeed, at current tax rates, revenues would have been more than sufficient to meet expenses if the system had ever accommodated either the decline in birth rates or the increasing life span of recipients.

Suppose, for instance, people would simply retire for the same number of years today as they did in 1940, when benefits were first paid. At that time, the average retirement age was 68, as it was in 1950 (Johnson, Mermin, and Steuerle 2006; Steuerle 2005). An equivalent retirement age in 2010, in expected years spent in retirement, would be about 75 (figure 5). By 2070 or so, it would be 80. However, people are now retiring earlier than they did 50 years ago—on average at about age 64, partly because of the decline in the earliest retirement age to 62—even as people live longer. By this calculation, current imbalances are simply the result of more years in retirement. If old age is defined by something like the last 10 or 15 years of expected life, then Social Security has morphed into a middle-age retirement system. We are not suggesting here that the number of years of support in 1940 were adequate or should be restored, only that today’s budgetary imbalance is reflected in an increased focus on those who are less old.

At the same time, the birth rate has declined significantly. Unlike longer lives, lower birth rates eventually increase the relative portion of the population that is in their last 10 or 15 years of life. Assuming even a constant number of years of retirement support over time, therefore, lower birth rates will reduce the number of workers available to pay taxes to support retirees. And a society must decide how to make the necessary adjustment in either taxes or benefits.

The combined effect of these demographic changes has been to reduce the worker-to-beneficiary ratio. At a level of 4-to-1 in the 1960s, more recently it has hovered above 3-to-1 and is scheduled to drop to 2-to-1 by the 2030s (Board of Trustees 2009). In a pay-as-you go system, an immediate drop from 3-to-1 to 2-to-1 would
require a 50 percent increase in tax rates to maintain benefit levels, or benefit rates have to fall by 33 percent to maintain the tax rate. Although trust funds can complicate the calculation, this is essentially the calculus behind all the long-run projections of revenues relative to benefits by the time the baby boomers have retired. Thereafter, an assumption of level birth rates going forward largely leads to costs remaining at a permanently higher level.

When people retire, they not only start drawing government benefits, they also stop generating income for themselves and stop paying revenues into both the Social Security and other tax systems. This relative decline in Social Security revenues by itself reduces the lifetime benefits that can be paid under any given Social Security tax rate, and it reduces income and other tax revenues for other government programs.

In the context of the larger budget, these demographic changes are felt far beyond the increase in Social Security beneficiaries. Likewise, adjustments that would mitigate these demographic trends extend far beyond Social Security:

- Higher adult employment rates increase national output and income;
- smaller shares of a lifetime spent in retirement increases one’s lifetime income;
- smaller shares of a lifetime spent in retirement increase the number of years one saves and decrease the number of years one is likely to dissave and draw down assets;
- more work increases federal and state income taxes;
- more work increases Social Security taxes available to pay Social Security benefits; at any tax rate, it increases average lifetime benefit payable;
- fewer years in retirement increases significantly the annual benefit payable or the replacement rate to an individual since lifetime benefits are withdrawn over a shorter period; and
- more work increases Medicare taxes and other taxes that support other programs.

In effect, the demographic pressures on the budget have implications far beyond Social Security. The inverse is that Social Security reforms—particularly those that increase the projected adult employment rate—can relieve budgetary pressures in ways that extend far beyond any calculations on Social Security finances alone.
An Elderly Issue?

Reforming Social Security to help address our budget woes is sometimes discussed as an “elderly” issue. This is misleading. Almost no suggested reforms would harm today’s older Americans because no proposal anywhere reduces the benefit on which they currently rely.

The only exception in many proposals put forward to date is a possible change in the cost-of-living adjustment (COLA) once retirees begin collecting benefits. But this proposal is based on the notion that the current adjustment more than compensates for inflation and that reforming COLAs would still maintain real benefits in retirement, instead of increasing them over time. And some suggested reforms—such as a minimum benefit—might actually help today’s elderly.

This is not to say that other budget adjustments would not affect the elderly. Proposed increases in various taxes could affect the elderly: new value-added taxes, higher sales taxes by states, higher fees for government-provided health care, and so forth. The recently passed health reforms, for example, might lower benefits or quality of providers in Medicare Advantage plans. Our point here is not to assess the merit of these alternatives, only to make clear that undertaking Social Security reform itself is among the least likely of all budget reform efforts to have any negative effect on the benefits of the current elderly.

In effect, the main people affected by Social Security reform are the middle-aged and the young—those who would be future retirees under Social Security. The imbalance in both the overall budget and in Social Security itself stems from a benefit growth rate that exceeds the revenue growth rate. The nonelderly must decide whether they want to slow the growth in benefits for themselves when they retire in order to provide more for other programs, such as education or wage subsidies, or to raise tax rates even more on themselves and their children.

Reforming Social Security as part of any budget reform, therefore, is not an elderly issue; it is an issue for citizens of all ages and primarily for those who are not currently elderly.

Conclusion

Social Security’s role as the flagship for social welfare policy places it in a unique place to lead the efforts for budget reform. Considered in isolation, fixing Social Security’s internal finances is a moderate issue in the budget relative to ever-increasing health care and interest costs. Nonetheless, Social Security reform could demonstrate to both ourselves and our foreign creditors that we are resolved to deal with the long-term budget problems. In particular, it would indicate that we are willing to give up something, somewhere, at some time—in the form of a lower growth rate in benefits, higher taxes, or more years of work—for the nation’s best interest.

Social Security reform could have a profound indirect effect on other public and private policies. Most important, it could generate higher output, income, and non-Social Security revenues by encouraging more work. The changes in Social Security—no matter what they may be or when they are finally adopted—will inevitably affect future generations’ contributions and expected benefits from the system, but today’s beneficiaries are likely to see only minimal changes in the benefits they receive. It is in the hands of future beneficiaries and taxpayers to decide what role Social Security should play in their lives—and the makeup of the government budget—in years to come.

Notes

1. In fact, the budget anticipates deficit reductions of more than $700 billion by 2015; the additional $300 billion in deficit reduction is accounted for by reducing spending on the rest of government.

3. The one exception is the 1983 reform that required a gradual increase in the normal retirement age from age 65, eventually reaching age 67 for those born in 1960 or later; if individuals do not adjust their retirement age, then the percentage growth in annual benefits is smaller.

References


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