

# Social Security Isn't Broken

## So Why Does Greenspan Want to Fix It?

BY DOUG ORR

**F**ederal Reserve Chairman Alan Greenspan told Congress earlier this year that everyone knows there's a Social Security crisis. That's like saying "everyone knows the earth is flat."

Starting with a faulty premise guarantees reaching the wrong conclusion. The truth is there is no Social Security crisis, but there is a potential crisis in retirement income security and there may be a crisis in the future in U.S. financial markets. It's this latter crisis that Greenspan actually is worried about.

Social Security is the most successful insurance program ever created. It insures millions of workers against what economists call "longevity risk," the possibility they will live "too long" and not be able to work long enough, or save enough, to provide their own income. Today, about 10% of those over age 65 live in poverty. Without Social Security, that rate would be almost 50%.

Social Security was originally designed to supplement, and was structured to resemble, private-sector pensions. In the 1930s, all private pensions were defined-benefit plans. The retirement benefit was based on a worker's former wage and years of service. In most plans, after 35 years of service the monthly benefit, *received for life*, would be at least half of the income received in the final working year.

Congress expected that private-sector pensions eventually would cover most workers. But pension coverage peaked at 40% in the 1960s. Since then, corporations have systematically dismantled pension systems. Today, only 16% of private-sector workers are covered by defined-benefit pensions. Rather than supplementing private pensions, Social Security has become the *primary* source of retirement income for almost two-thirds of retirees. Thus, Congress was forced to raise benefit levels in 1972.

What has happened to private-sector defined benefit pensions? They've been replaced with defined-contribution (DC) savings plans such as 401(k)s and 403(b)s. These plans provide some retirement income but offer no real protection

from longevity risk. Once a retiree depletes the amount saved in the plan, that pension is gone.

In a generous DC plan, a firm might match the worker's contribution up to 3% of his or her pay. With total contributions of 6%, average wage growth of 2% a year, and an average return on the investment portfolio of 5%, after 35 years of work, a retiree would exhaust the plan's savings in just 8.5 years even if her annual spending is only half of her final salary. If she restricts spending to just one-third of the final salary, the savings can stretch to 14 years.

At age 65, life expectancy for women today is about 20 years, and for men about 15 years, so DC savings plans will not protect the elderly from longevity risk. The conversion of defined-benefit pensions to defined-contribution plans is the source of the real potential crisis in retirement income. Yet Greenspan did not mention this in his testimony to Congress.

### NO CRISIS

Opponents of Social Security have hated it since its creation in 1935. The first prediction of a Social Security crisis was published in 1936! The Heritage Foundation and Cato Institute are home to many of the program's opponents today, and they fixate on the concept of a "demographic imperative." In 1960, the United States had 5.1 workers per retiree, in 1998 we had 3.4, and by 2030 we will have only 2.1. Opponents claim that with these demographic changes, revenues will eventually be insufficient to pay Social Security retirement benefits.

The logic is appealingly simple, but wrong for two reasons. First, this "old-age dependency" ratio in itself is irrelevant. No amount of financial manipulation can change this fact: all current consumption must come from current physical output. The consumption of all dependents (non-workers) must come from the output produced by current workers. It's the *overall* dependency ratio—the number of *workers* relative to *all non-workers*, including the aged, the

young, the disabled, and those choosing not to work—that determines whether society can “afford” the baby boomers’ retirement years. In the 1960s we had 1.05 workers for each dependent, and we were building new schools and the interstate highway system and getting ready to put a man on the moon. No one bemoaned a demographic crisis or looked for ways to cut the resources allocated to children; in fact, the living standards of most families rose rapidly. In 2030, we will have 1.27 workers per dependent. We’ll have more workers per dependent in the future than we did in the past. While it is true a larger share of total output will be allocated to the aged, just as a larger share was allocated to children in the 1960s, society will easily produce adequate output to support all workers and dependents, and at a higher standard of living.

Second, the “demographic imperative” ignores productivity growth. Average worker productivity has grown by about 2% per year, adjusted for inflation, for the past half-century. That means real output per worker doubles every 36 years. This productivity growth is projected to continue, so by 2040, each worker will produce twice as much as today. Suppose each of three workers today produces \$1,000 per week and one retiree is allocated \$500 (half of his final salary)—then each worker gets \$833. In 2040, two such workers will produce \$2,000 per week each (after adjusting for inflation). If each retiree gets \$1,000, each worker still

gets \$1,500. The incomes of both workers and retirees go up. Thus, paying for the baby boomers’ retirement need not decrease their children’s standard of living.

So why the talk of a Social Security crisis? Social Security always has been a pay-as-you-go system. Current benefits are paid out of current tax revenues. But in the 1980s, a commission headed by Greenspan recommended raising payroll taxes to expand the trust fund in order to supplement tax revenues when the baby boom generation retires. Congress responded in 1984 by raising payroll taxes significantly. As a result, the Social Security trust fund, which holds government bonds as assets, has grown every year since. As the baby boom moves into retirement, these assets will be sold to help pay their retirement benefits.

Each year, Social Security’s trustees must make projections of the system’s status for the next 75 years. In 1996, they projected the trust fund balance would go to zero in 2030. In 2000, they projected a zero balance in 2036 and today they project a zero balance in 2042. The projection keeps changing because the trustees continue to make unrealistic assumptions about future economic conditions. The current projections are based on the assumption that annual GDP growth will average 1.8% for the next 75 years. In no 20-year period, even including the Great Depression, has the U.S. economy grown that slowly. Each year the economy grows faster than 1.8%, the zero balance date moves

further into the future. But the trustees continue to suggest that if we return to something like the Great Depression, the trust fund will go to zero.

Opponents of Social Security claim the system will then be “bankrupt.” Bankruptcy implies ceasing to exist. But if the trust fund goes to zero, Social Security will not shut down and stop paying benefits. It will simply revert to the pure pay-as-you-go system that it was before 1984 and continue to pay current benefits using current tax revenues. Even if the trustees’ worst-case assumptions come true, the payroll tax paid by workers would need to increase by only about 2%, and only in 2030, not today.

If the economy grows at 2.4%—which is still slower than the stagnant growth of the 1980s—the trust fund never goes to zero. The increase in real output and real incomes will generate sufficient revenues to pay promised benefits. By 2042, we will need to *lower payroll taxes or raise benefits* to reduce the surplus.

#### HOW DOES THE BOND MARKET WORK?

A bond is nothing more than an IOU. A company or government borrows money and promises to pay a certain amount of interest annually until it repays the loan. When you buy a newly issued bond, you are making a loan. The amount of the loan is the “face value” of the bond. The initial interest rate at which the bond is issued, the “face rate,” multiplied by this face value determines the amount of interest paid each period. Until the debt is paid back, events in the financial markets affect the bond’s value.

If market interest rates fall, prices of existing bonds rise. Why? Suppose you buy a bond with a face value of \$100 that pays 10%. You then collect \$10 per year. If the current interest rate falls to 5%, newly issued bonds will pay that new rate. Since your bond pays 10%, people would rather buy that one than one paying 5%. They are willing to pay more than the face value to get it, so the price will be bid up until interest rates equalize. The price at which you could sell your bond will rise to \$200, since \$10 is 5% of \$200.

But changes in bond prices also affect interest rates. If more people are selling bonds than buying them, an excess supply exists, and prices will fall. If you need to sell your bond to get money to pay your rent, you might have to lower the price of the bond you hold to \$50. Because the bond still pays \$10 per year to the owner, the new owner gets a 20% return on the \$50 purchase. Anyone trying to issue new bonds will have to match that return, so the new market interest rate becomes 20%.

## THE REAL FEAR: AN OVERSUPPLY OF BONDS

So why did Greenspan claim cutting benefits would become necessary? To understand the answer, we need to take a side trip to look at how bonds and the financial markets affect each other. It turns out that rising interest rates reduce the selling price of existing financial assets, and falling asset prices push up interest rates (see "How Does the Bond Market Work?" p. 15).

For example, in the 1980s, President Reagan cut taxes and created the largest government deficits in history up to that point. This meant the federal government had to sell lots of bonds to finance the soaring government debt; to attract enough buyers, the Treasury had to offer very high interest rates. During the 1980s, real interest rates (rates adjusted for inflation) were almost four times higher than the historic average. High interest rates slow economic growth by making

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it more expensive for consumers to buy homes or for businesses to invest in new infrastructure. The GDP growth rate in the 1980s was the slowest in U.S. history apart from the Great Depression.

But high interest rates also depress financial asset prices. A five percentage point rise in interest rates reduces the selling price of a bond (loan) that matures in 10 years by 50%. It was the impact of the record-high interest rates of the 1980s on the value of the loan portfolios of the savings and loan industry that caused the S&L crisis and the industry's collapse.

Greenspan is worried because he sees history repeating itself in the form of President Bush's tax cuts. In his testimony, Greenspan expressed concern over a potentially large rise in interest rates. This is his way of warning about an excess supply of bonds. Starting in 2020, Social Security will have to sell about \$150 billion (in 2002 dollars) in trust fund bonds each year for 22 years. At the same time, private-sector pension funds will be selling \$100 billion per year of financial assets to make their pension payments. State and local governments will be selling \$75 billion per year to cover their former employees' pension expenses, and holdings in private mutual funds will fall by about \$50 billion per year as individual retirees cash in their 401(k) assets. Private firms will still need to issue about \$100 billion of new bonds a year to finance business expansion. Combined, these asset sales

could total \$475 billion per year.

This level of bond sales is more than double the record that was set in the 1980s following the Reagan tax cuts. But back then, the newly issued bonds were being purchased by "institutional investors" such as private-sector pension funds and insurance companies. After 2020, these groups will be net sellers of bonds. The financial markets will strain to absorb this level of asset sales. It's unlikely they will be able to also absorb the extra \$400 billion per year of bond sales needed to cover the deficit spending that will occur if the new Bush tax cuts are made permanent. This oversupply of bonds will drive down the value of all financial assets.

In a 1994 paper, Sylvester Schieber, a current advisor to President Bush on pension and Social Security reform, predicted this potential drop in asset prices. After 2020, the value of assets held in 401(k) plans, already inadequate, will be reduced even more. More importantly, at least to Greenspan, the prices of assets held by corporations to fund their defined benefit pension promises will fall. Thus, pension payments will need to come out of current revenues, reducing corporate profits and, in turn, driving down stock prices.

It's this potential collapse in the prices of financial assets that worries Greenspan most. In order to reduce the run-up of long-term interest rates, some asset sales must be eliminated. Greenspan said, "You don't have the resources to do it all." But rather than rescinding Bush's tax cuts, Greenspan favors reducing bond sales by the Social Security trust fund. Doing that requires a reduction in benefits and raising payroll taxes even more.

Framing a question incorrectly makes it impossible to find a solution. The problem is not with Social Security, but rather with blind reliance on financial markets to solve all economic problems. If the financial markets are likely to fail us, what is the solution? The solution is simple once the question is framed correctly: where will the *real output* that baby boomers are going to consume in retirement come from?

The federal budget surplus President Bush inherited came entirely from Social Security surpluses resulting from the 1984 payroll tax increase. Bush gave away revenues meant to provide for workers' retirement as tax cuts for the wealthiest 10% of the population.

We should rescind Bush's tax cuts and use the Social Security surpluses to really prepare for the baby boom retirement. Public investment or targeted tax breaks could be used to encourage the building of the hospitals, nursing homes, and hospices that aging baby boomers will need. Such investment in public and private infrastructure would also stimulate the real economy and increase GDP growth. Surpluses could be used to fund the training of doctors, nurses and others to staff these facilities, and of other high skilled workers more generally. The higher wages of skilled labor will help generate the payroll tax revenues needed to fund future benefits.

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If baby boomers help to fund this infrastructure expansion through their payroll taxes while they are still working, less output will need to be allocated when they retire. These expenditures will increase the productivity of the real economy, which will help keep the financial sector solvent to provide for retirees.

Destroying Social Security in order to "save" it is not a solution.

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**RESOURCES** Dean Baker and Mark Weisbrot, *Social Security: The Phony Crises*, University of Chicago Press, 1999; William Wolman and Anne Colamosca, *The Great 401(k) Hoax*, Perseus Publishing, 2002; Sylvester J. Schieber and John B. Shoven, "The Consequences of Population Aging on Private Pension Fund Saving and Asset Markets," National Bureau of Economic Research, Working Paper No. 4665, 1994.