

# What You Need to Know About Social Security



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## INTRODUCTION

**T**HE Federal program officially titled Old-Age, Survivors, and Disability Insurance, or OASDI, better known as Social Security, seeks to prevent poverty resulting from old age, retirement, the death of an income-earning spouse or parent, or disability.

About 162 million people pay taxes on labor income to finance Social Security's benefits to retired workers, their survivors, and disabled Americans. Both the Social Security tax rate and the maximum amount of income subject to the tax have risen to substantial levels, and for a great many taxpayers, Social Security taxes take more of their earnings than income taxes.

Roughly 49 million Americans were receiving Social Security benefits at the end of 2006: 34 million retired workers and their dependents; seven million survivors of deceased workers, and nine million disabled workers and their dependents. For many of them, such benefits are their major, or even their only, source of retirement income.

Thus, Social Security figures importantly in the lives of almost all Americans, and the outlook for Social Security is a major national concern. Within the next 20 years, it is virtually certain that because of increased life expectancy and the retirement of the large "baby boom" generation born between 1945 and 1965 (who will have to be supported by the smaller generations born after 1965), the Social Security system's outlays will begin to exceed revenues by an ever increasing margin.

In the next few years, therefore, America will need to make major decisions about Social Security. These decisions will affect you in important ways: your tax bill, how much you will receive in Social Security benefits, and when you will retire—if you will be able to retire while maintaining an acceptable standard through your old age.

While critical examinations of Social Security are now proliferating, the American Institute for Economic Research can proudly claim the title of pioneer. We gave Social Security critical scrutiny from its very beginning. In August 1935, the same month in which Social Security became law, AIER pointed out the depressive effects Social Security's taxes were likely to have on savings and capital and the program's apparent unconstitutionality. In January 1939, when the first major amendment, and liberalization, of Social Security was proposed, the Institute warned presciently that Social Security

“will burden the present younger generation, and those to come, far more than is generally understood,” and that that burden “may be greater than can be undertaken without serious damage to our economic system.”<sup>1</sup>

The Institute’s founder, E. C. Harwood, was perhaps the harshest critic in print of Social Security from the 1930s until he died in 1980. He labeled Social Security a Ponzi scheme, pure and simple, and ranked it among the three greatest swindles perpetrated by government in human history—a fraud that not only burdened younger and future generations in order to enrich current retirees, but also retarded capital formation, employment, and, most important, individual initiative and responsibility.<sup>2</sup> Its combined effects over the long term, he noted, could be expected not to promote, but to curtail, improvements in standards of living.

AIER has since examined many aspects of Social Security, *e.g.*, the retirement earnings test; anomalies of benefit calculation; the Social Security trust fund and its role in Federal budget accounting; and the putative “returns” on Social Security taxes compared to what one could earn investing the same sums in private instruments. Harwood also recognized that the consequences of unwinding such massive frauds as Social Security are never painless and often create new opportunities for even greater mischief. With this in mind, AIER has addressed the vexing question of what to do about Social Security, taking a hard look at various reform proposals and offering solutions of its own.

Social Security is very important both in our national life and in the lives of individuals. It is vital that you have a clear understanding of what Social Security is and what it is not; how it developed; its myths and realities; the nature of its coming crisis; the options for Social Security reform; and how Social Security’s crisis is likely to affect you. This book seeks to meet that need.

The original version of this booklet (published in 2003) was prepared by the late Dr. John Attarian (1956-2004), a preeminent authority on the topic. This edition has been revised and updated by Charles Murray and Leighton Smith, with the supervision of Kerry A. Lynch, Director of Research and Education.

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<sup>1</sup> American Institute for Economic Research, *Monthly Bulletin*, August 1935, and “Whither Social Security?” in American Institute for Economic Research, *Weekly Bulletin*, January 23, 1939.

<sup>2</sup> The other two he named were monetary inflation, which robbed the thrifty of their savings, and the establishment of the Securities and Exchange Commission, which gave investors unwarranted confidence in new, untested, securities.

## I.

### A BRIEF HISTORY OF SOCIAL SECURITY

**S**TATE-ADMINISTERED “social insurance” financed by taxes on payrolls originated in Germany under Otto von Bismarck. He believed that measures such as his Sickness Insurance Law (1883), Accident Insurance Law (1884), and Old Age and Disability Insurance Law (1889) would make German industrial workers less receptive to socialism. Other European countries followed with similar programs, most notably Great Britain’s National Insurance Act (1911), which provided compulsory sickness and unemployment insurance.

In the United States prior to the 1930s, family members and private charities (as well as limited government relief) provided care for the elderly, the disabled and the unemployed. Numerous intellectuals in the latter half of the 19th century and early 20th century agitated for government action to relieve these and other hardships. Some states enacted social insurance programs providing unemployment and old-age benefits, but many academics, labor unions, social workers and social insurance advocates such as Isaac Rubinow and Abraham Epstein called for national social insurance, citing the European precedents.

They made little headway until the Great Depression, when unemployment was very high among the elderly as well as the young. Declining birth rates led to smaller families that were less capable of caring for their own. Moreover, many Americans who prudently had accumulated assets for their old age were wiped out by the Crash, bank failures and bankruptcies. By the end of 1934 some 750,000 elderly Americans were on federal relief. Many private charities and pension plans were collapsing for want of funds. State-run old-age assistance programs were passed in response to the plight of the aged, but were crippled by inadequate revenues and severe restrictions and covered less than 200,000 citizens.

As governor of New York, Franklin Roosevelt had repeatedly sought enactment of old-age insurance financed by “premiums” paid by young workers, employers and the state government. He proposed old-age insurance during the 1932 presidential campaign. In 1933, President Roosevelt tried hard to promote social insurance to his administration, the Congress and the country. In 1934 he created a Committee on Economic Security

and panels of expert advisers to develop an economic security program of social insurance to propose to Congress.

Meanwhile, support was banding together on the political left for radical changes in how America provided for the aged. Most noteworthy, the famous Townsend Movement began in 1933, when a California physician, Dr. Francis Townsend, proposed a plan to relieve old-age poverty by paying every American aged 60 and over a monthly \$200 pension, financed by a “revolving pension fund” of sales tax revenues, on the condition that the beneficiary retire and spend the pension within a month of receiving it.

The Townsend Plan had enormous appeal to the elderly, and a nationwide movement, with millions of members, arose to promote it and pressure Congress to enact it. Roosevelt warned his Committee on Economic Security that any proposal had to include old-age insurance to enable Congress and the administration to withstand the pressure of the Townsendites. Some scholars argue that Social Security was a response to the Townsend Movement. While the Movement did weaken congressional resistance to the administration’s proposals, it probably only expedited enactment of a program that Roosevelt already wanted.

### *The Social Security Act of 1935*

Introduced in Congress on January 17, 1935, the administration’s economic security bill was a comprehensive package of measures: old-age assistance for poor persons who were already elderly and hence could not draw benefits under social insurance because eligibility was based on previous employment in covered occupations; aid to families with dependent children; maternal and child health care, especially for persons in rural and distressed areas; unemployment insurance; and the old-age program, Social Security. Interestingly, the original bill also contained a provision for voluntary purchase of annuities from the government, which was deleted.

There were other changes as well. Treasury Secretary Henry Morgenthau, with Roosevelt’s approval, insisted that tax rates be raised enough to create a large reserve fund, projected to reach \$50 billion by 1980, to help defray future expenses. Also, the bill was purged of insurance language, because the administration and its allies in Congress feared that the Supreme Court would invalidate a government program of compulsory, tax-funded old-age insurance.

Roosevelt signed the Social Security Act into law on August 14, 1935.

Titles II and VIII contained Social Security's benefit and tax provisions. Title VIII, Taxes with Respect to Employment, levied taxes on wages received after December 31, 1936, in employment other than agricultural labor, domestic service, casual labor outside one's line of work, employment in state or local government, work on a vessel or employment in a nonprofit organization. The tax rate for calendar 1937-9 was one percent; it would be 1.5 percent for 1940-2, two percent in 1943-5, 2.5 percent in 1946-8, and three percent thereafter. Employers would pay matching taxes. The maximum annual income subject to the tax was \$3,000.

Title II, Federal Old-Age Benefits, created an "Old-Age Reserve Account" at the Treasury. Every fiscal year, funds deemed sufficient to pay benefits were to be appropriated to the Account by Congress. Amounts appropriated but not needed for current benefit outlays were required to be invested in interest-bearing U.S. government debt, including special unmarketable debt created for this purpose and earning three percent a year, and debt whose principal and interest were guaranteed by the government.

Monthly benefit payments were to begin on January 1, 1942, to qualified individuals—that is, persons who were at least 65 years old who had been paid wages for employment on at least five days between December 31, 1936 and their 65th birthday, and who had earned at least \$2,000 in that period in occupations other than the exceptions mentioned above. However, another provision, which became known as the "retirement earnings test," stipulated that the beneficiary had to be retired in order to collect benefits; otherwise, he would lose his entire benefit for every month in which he received wages from employment covered by the Act. Benefits were based on earnings during the period from the end of 1936 to one's 65th birthday. The smallest monthly benefit was \$15, the largest \$85.

If the beneficiary died before turning 65, his estate would receive a lump sum equal to 3.5 percent of his wage income since the end of 1936. If he turned 65, began collecting monthly benefits and then died, his estate would get a lump sum large enough to raise his total benefits to 3.5 percent of his wage earnings since the end of 1936. If an individual had worked in an occupation covered by the Act and had turned 65 without qualifying for monthly benefits, he would get a lump sum equal to 3.5 percent of his wage earnings since 1936. In short, the original Act provided that the worker—or his estate—would always receive at least as much as he had paid in: a money-back guarantee.

There were some telling omissions. The Act said nothing about contracts, insurance, rights or guarantees. And the Act said nothing about the money in the Account belonging to the workers who had paid it, or a trust fund holding their money for them, or about their money being held in individual accounts.

Title VII created a three-member Social Security Board to head the administration of Social Security and report regularly to Congress on how the program was being run. The Act included, in Title XI, General Provisions, a “reservation of power” clause, Section 1104: “The right to alter, amend, or repeal any provision of this Act is hereby reserved to the Congress.” Such reservation of power is routine in acts of Congress, but it carries momentous implications, given the way Social Security has been presented to the public, the public’s understanding of the program and the realities of the Social Security system.

Although the Act contained no insurance or rights language, the Roosevelt administration began describing Social Security as “annuities” or “insurance” paying benefits “as a matter of right.”<sup>3</sup> In this it was seconded by newspapers and magazines, and by Democratic politicians, including President Roosevelt himself.

On May 24, 1937, in the *Helvering v. Davis* decision, the Supreme Court voted 7-2 to find Social Security constitutional, probably to fend off Roosevelt’s proposal to pack the Court, which Congress was considering at that time. *Helvering v. Davis* cleared the way for Social Security’s administrators to resume marketing the program as insurance.\* Social Security literature explaining the program to the public was rewritten to insert insurance language.

### *The 1939 Amendments*

In 1939, the Social Security Act was substantially amended. These changes had far-reaching consequences for both the public’s perception of Social Security and for its realities.

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<sup>3</sup> Frances Perkins, “Social Security: The Foundation,” *New York Times Magazine*, August 18, 1935, pp. 2, 15; A. J. Altmeyer, “The New Social Security Act,” *Vital Speeches of the Day*, October 7, 1935, p. 8.

\* For a discussion of Roosevelt’s infamous Court-packing scheme, see Roger Pilon, “The United States Constitution: From Limited Government to Leviathan,” AIER’s December 2005 *Economic Education Bulletin*.

## **Insurance vs. Welfare vs. Social Insurance**

The purpose of insurance is to protect against quantifiable risks. Those subject to a given risk contribute small amounts of money to create a fund large enough to compensate for the losses of those who have contributed to the fund and for whom the risk has become a reality. Insurance thus creates the certainty of a small loss to forestall the possibility of a large loss. To receive a claim, the insured need only demonstrate that the event covered by the insurance has occurred. Insurance contracts are based on the principle of individual equity—the individual gets the benefits that he or she has paid for.

*Welfare*, on the other hand, involves using public funds to provide relief to those in need of support. To receive relief, a person must demonstrate need, usually via a means test. The rationale for welfare is social equity—the notion that a society needs to support those who, for one reason or another, cannot support themselves.

Social insurance is, at its most basic level, not insurance at all, but welfare without a means test. Tax revenues are used to make payments to beneficiaries; but, to receive such payments, one only needs to be facing specific conditions, such as advanced years, disability or unemployment, as defined by law. The amount of any benefits may be related to the individual's work history rather than any demonstration of hardship or need, which can give social insurance some of the trappings of genuine insurance.

But there are two reasons social insurance is not genuine insurance. First, a properly managed insurance program will maintain enough funds on hand to meet future claims, even if there are no further contributions from those who are insured. Social insurance programs seldom accumulate sufficient funds to pay future claimants, but pay beneficiaries out of current contributions (tax receipts) from others.

Second, social insurance benefits are typically skewed in ways designed to favor those whom the designers of the system believe are likely to be poor. For example, the retirement benefits will replace a larger proportion of preretirement wages for persons with a history of relatively low wages than for those with a history of relatively high wages. Such skewing violates the principal of individual equity that is central to genuine insurance.

Pressure was rising for liberalization of Social Security. An influential article by insurance executive Reinhard Hohauser argued that Social Security should be expanded and should stress the social insurance principle of social equity while downplaying individual equity. The administration also wanted Social Security expanded. The Townsend Movement, still powerful, attacked Social Security's benefits as stingy—a criticism also employed by Republicans.

Meanwhile, controversy was raging about the Old-Age Reserve Account. Beginning with 1936 Republican presidential candidate "Alf" Landon, critics had charged that the reserve fund to be built up from surplus appropriations to the Old-Age Reserve Account was a sham; the government would simply spend the surpluses on general expenses and issue itself an IOU (the special debt instruments). The reserve fund thus would have nothing to pay future benefits with; Americans would have to be taxed all over again to redeem the IOUs with interest.

The reserve was real, its defenders retorted; government debt was one of the safest assets. Besides, the surpluses had nowhere else to go—holding cash was silly, and the Act did not authorize purchase of private securities. Social Security's partisans realized that if the program was liberalized without raising taxes, this would preclude accumulation of a large reserve, and help end the controversy.

For all these reasons, the 1939 Amendments to the Social Security Act significantly liberalized the program. Survivor's benefits for dependent wives, children, widows and parents were added. Retirement benefits were increased. Also, benefit payments would start on January 1, 1940, rather than 1942.

However, taxes were not increased and other benefits were cut to keep the cost down. The lump-sum death benefit to the estate of persons under 65, originally equal to 3.5 percent of wage income since 1936, was cut to six months' benefits, paid to the widow, widower, child or parent of the deceased. The other lump-sum benefits were dropped altogether.

Termination of the money-back guarantee and scaling back of the death benefit were, of course, permissible under Section 1104. These changes demonstrated that Congress could adjust benefits down as well as up—even eliminate them altogether—and that therefore one's "earned right" was not set in stone.

The removal of the money-back guarantee also substantially diluted the

principle of individual equity, thereby greatly weakening Social Security's resemblance to insurance. Yet the selfsame amendments also officially relabeled Social Security as "insurance!" The insurance language removed from the original bill was restored. The Amendments titled the program "Old-Age and Survivors Insurance." Social Security's taxes were relabeled "contributions." Title VIII of the Social Security Act was transferred to the Internal Revenue Code as the Federal Insurance Contributions Act (FICA).

An Old Age and Survivors Insurance Trust Fund was created at the Treasury. It had the same nature and functions as the Old Age Reserve Account. The only crucial difference was that whereas the original Act stipulated that Congress would appropriate monies to the Old Age Reserve Account annually, the amendments called for appropriating to the Trust Fund an amount equivalent to 100 percent of the revenue raised by the FICA taxes automatically each fiscal year beginning with the one ending June 30, 1941. A Board of Trustees was created to manage the Trust Fund.

In short, the 1939 Amendments wrote into the law the semantic and institutional framework—"insurance," "contributions," and a sham "trust fund"—that has been used ever since to promote Social Security and to shape the public's understanding of the program. Yet the fate of the lump-sum benefits and the money-back guarantee proved that the impression of certainty and security given by this language, and the phrase "earned right," were illusions.

### ***Misleading Marketing***

The campaign to market Social Security after the Amendments was therefore highly misleading. The September 1939 pamphlet *Changes in the Social Security Act: Old-Age Insurance*, for example, said in part:

*It is an insurance plan* [italics in original]. You pay a tax, and so does your employer, to help pay the cost of the benefits you will receive. In other words, you pay a sort of premium on what might be called an insurance policy which will begin to pay benefits to you when you are 65 or over, or to your family when you die.<sup>4</sup>

Likewise, leaflets and circulars published in 1940 frequently used the word "insurance" and stated that the tax money "goes into the Old-Age

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<sup>4</sup> Social Security Board, *Changes in the Social Security Act: Old-Age Insurance*, I.S.C. no. 35, temporary edition, September 1939, p. 3.

and Survivors Insurance Trust Fund under the United States Treasury, from which insurance benefits are paid,” and that the taxes are “similar to premiums paid on an insurance policy.” The 1943 *Old-Age and Survivors Insurance for Workers and their Families* added, “because the worker has helped to pay for his benefits, they come to him and his family *as a matter of right* (our italics).”<sup>5</sup>

Mainstream media uncritically echoed all this. Magazines such as *Newsweek* and *United States News* referred to Social Security as “insurance,” to the government as “in effect... writ[ing] insurance policies guaranteeing to pay monthly benefits,” to taxes as “premiums,” to benefits as “available as a matter of right” and to beneficiaries as “policyholders.”<sup>6</sup>

### ***Further Expansions***

In 1950, coverage was extended to most nonagricultural self-employed, and to regularly employed farm and domestic workers. All persons aged 62 and over could now become eligible to receive full benefits with just six quarters of coverage—a great departure from individual equity, further weakening the analogy with insurance. Benefits were increased by an average of 77 percent, slightly exceeding total price inflation since 1937. The tax rate had been frozen at the initial one percent; the 1950 legislation raised it to 1.5 percent each for employers and employees, and added a self-employment tax for the self-employed now participating.

Another massive expansion occurred in 1954. Compulsory participation was extended to self-employed farmers, other farm and domestic employees not added by the 1950 Amendments, various self-employed professionals, such as architects, and miscellaneous other occupations. Four million persons were given the option of participating in Social Security, mostly state and local employees who already had their own retirement programs, clergy and members of religious orders. Almost every occupation was now

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<sup>5</sup> Social Security Board, *2 Plans for Old-Age Security*, I.S.C. no. 42, n.d., pp. 1-3; Social Security Board, *What is Social Security? A Brief Explanation*, I.S.C. no. 1, July, 1940, p. 10; Social Security Board, *Old-Age and Survivors Insurance for Workers and their Families*, I.S.C. no. 35, January 1943, p. 3.

<sup>6</sup> “The New Social Security System: Questions, Answers for Workers, Employers,” *United States News*, August 14, 1939, p. 3; “U.S. Social Security Payoff Starts in New Year for 912,000,” *Newsweek*, December 25, 1939, p. 10; “Billions for the Old Folks,” *United States News*, January 5, 1940, p. 18; “Social Security Plan: Five Front Extension of Act Would Add 27 Million to Rolls,” *Newsweek*, October 13, 1941, p. 17.

covered except for a few professions and federal workers. Roughly 6.6 million beneficiaries received a 13 percent increase in benefits. All this would of course increase future costs, and the tax rates scheduled for the 1970s were raised accordingly.

In 1956, Disability Insurance was added, paying monthly benefits to totally or partially disabled workers ages 50 to 64. Benefits would also go to dependent children aged 18 or older who had become totally disabled before turning 18. The Disability Insurance Trust Fund was created to pay these benefits. The Social Security tax was raised to cover the costs, by 0.25 percent of taxable payroll each for workers and employers, and 0.375 percent for the self-employed, the revenues going to the DI Trust Fund.

Agitation began in the 1950s to add health care benefits. The 1965 Amendments created Medicare. In addition, Congress repeatedly increased OASDI benefits, partly as *ad hoc* adjustments for price inflation, and partly out of the generosity and ambition of politicians. In 1972, for example, President Richard Nixon and congressional Democrats competed in raising benefits in an election year. In these years benefits rose a total of 77 percent. Taxes were raised to cover the resultant higher projected costs. In 1972 a Cost of Living Adjustment (COLA) was added to adjust benefits annually for price inflation, beginning in 1975.

### ***The 1970s and 1980s: Crises and Rescues***

In the mid-1970s, Social Security's financial outlook collapsed. The 1974 *Annual Report* projected a large deficit over the 75-year period 1974 to 2048, and the following year's report almost doubled the projected deficit. The main reasons were the much higher future retirement costs due the babyboom generation born after World War II, the automatic indexation of benefits for price inflation and the fact that slower economic growth and a below-replacement fertility rate would yield more slowly growing, or perhaps even declining, revenues.

Also, for the first time, Social Security faced a *short-term* financial crisis. Unanticipated economic developments, including a deep recession followed by "stagflation" (simultaneous high unemployment and high price inflation), raised costs and depressed revenues. Moreover, apparently due to a drafting error, the cost-of-living adjustments enacted in 1972 resulted in benefits that were adjusted for price inflation twice.

Faced with the impending ruin of Social Security, Congress enacted legislation in 1977 undoing the double indexing of benefits. It also greatly increased both the payroll tax rate and the maximum income subject to tax, measures bitterly unpopular with taxpayers.

Although intended to solve the problem, the 1977 rescue was inadequate, and the high price inflation of the late 1970s again drove Social Security toward insolvency. In 1980 the Board of Trustees reported that Social Security had run a deficit of almost \$2 billion in fiscal 1979, and that its trust fund would run out by calendar 1985.

In 1981, President Ronald Reagan proposed cutting benefits to meet the crisis. Specifically, the early retirement (at age 62) benefit would have been cut from 80 percent of the age 65 amount to 55 percent; for 1982-7, the formula used to calculate the age 65 benefit level would have had its “bend points,” which skew the level of benefits in favor of lower-income workers, increase by 50 percent of the increase in the average annual wage, not 100 percent; the date for the annual cost of living adjustment would have been changed from June to December; and disability benefit requirements were to have been tightened. Opposition was immediate and ferocious; Reagan suffered his first defeat in Congress. A chastened Reagan appointed a bipartisan commission chaired by economist Alan Greenspan to recommend modifications to Social Security to avert insolvency.

Congress enacted sweeping changes in 1983 that closely followed the Greenspan Commission’s recommendations. These raised revenues and cut current and future benefits. The phasing-in of the 1977 tax increases was accelerated, with the 1985 increase taking effect in 1984, and the 1990 increase starting in 1988. The self-employment tax rate was increased to equal the sum of the employee and employer FICA rates. Benefit payments became subject to tax for the first time, in effect introducing a sort of means test (*i.e.*, those with substantial incomes over and above the Social Security benefits had to return a portion of those benefits in income taxes). As another revenue-raiser, Social Security was extended to all newly hired federal workers, the president, the vice-president, members of Congress, federal judges and other executive-level political appointees, and to most employees of nonprofit, charitable, educational and religious organizations. The provision whereby state and local employees could leave Social Security was rescinded.

The cost-of-living increases that were due in July 1983 were delayed

until January 1984. But most benefit cuts were to occur in the future. After 2000 the retirement age would be gradually raised and early retirement benefits gradually cut.

### *Subsequent Developments*

The 1977 and 1983 tax increases drove Social Security's revenues above outlays and, from 1985 on, OASDI reported increasingly large annual surpluses. Employment growth had been substantially larger, and wage and price increases markedly less, than the Greenspan Commission had anticipated. Also, the retirements of the relatively small birth cohorts born during the 1920s and 1930s meant that benefit payments grew relatively slowly.

Beginning in 1998, the OASDI surpluses exceeded \$100 billion a year. These monies accumulated in the Trust Fund as unmarketable Treasury debt. As of year-end 2006 the OASDI Trust Fund held \$2.048 billion. The availability and use of these monies for general government purposes led to charges, and widespread belief, that Congress was robbing the Trust Fund and squandering the reserve meant to help pay baby boomers' benefits—uncannily reminiscent of the reserve-fund controversy of the 1930s.

The 1983 legislation improved Social Security's outlook only temporarily. For that year the projected long-term, 75-year "actuarial balance" was +0.02 percent of taxable payroll. In other words, based on projected population, employment, wage rates, interest rates and price trends indicated that if the payroll tax rate was *reduced* by 2/100 of one percent, the system could still meet all its benefit obligations through the year 2058.

Almost immediately, however, the actuarial balance returned to deficit, reaching -2.23 percent in the Board of Trustees's *Annual Report* for 1997. In other words, their calculations for that year indicated that the payroll tax would have to be *increased* 2.23 percent if the system was to meet all its obligations through the year 2072. The actuarial balance has been in deficit between the range of -1.86 percent to -2.23 percent for the last 10 years and was -2.02 percent in the *Annual Report* of 2006.

Although successive Boards of Trustees reported that OASDI was not in long-term actuarial balance and requested remedial action, presidents and Congresses alike largely ignored Social Security's problems. The latest *Annual Report* concludes that for the trust funds to remain solvent throughout the 75-year projected period, the combined payroll tax rate would have to be increased during the period by 1.95 percentage points, benefits would have

to be reduced by 13 percent, \$4.7 trillion (in constant dollars) would have to be transferred from general revenue, or some combination of the three.

The Board recommended (again!) that the projected trust fund deficits be addressed in a timely way to allow for gradual phasing in and to provide advance notice to workers. Moreover, it offered to work with Congress (again!) to enact timely legislative action to address Social Security's problems.

Over the past decade, numerous reform bills have been introduced. As of this writing in mid-2007, however, none has been enacted. Argument and procrastination continue.

## II.

### SOCIAL SECURITY MYTHS AND REALITIES

A formidable body of misconceptions has grown up around OASDI. Unfortunately, these myths greatly influence the public's perceptions of the program and their attitudes toward revising it. Dispelling them is the first, and maybe the most difficult, obstacle that must be overcome to make way for useful reform.

#### *“Social Security is Insurance”*

Social Security was “sold” to the American people as insurance, probably because it would not have gained the widespread support it did had it not been made to appear like insurance rather than a dole. The payroll tax, widely described as a “contribution” or “premium,” created a powerful impression that the taxpayer was buying an annuity or old-age insurance. The writing of insurance language into the law in 1939, and the creation of the Trust Fund, strengthened the analogy.

The fact is, however, Social Security is not insurance. It lacks the characteristics of true insurance. For one thing, as former Social Security Commissioner Arthur Altmeyer admitted in the Social Security hearings held in 1953 by Congressman Carl T. Curtis, Social Security has no contract, and a beneficiary's rights are statutory, not contractual, and are subject to revision by Congress.

Moreover, insurance scholars describe insurance as a method of risk management employing *risk pooling* and *risk transfer*. Social Security contains neither. Under risk pooling, a large population of persons, each of whom faces the uncertain prospect of a large loss, shares the risk by means of each person paying a small sum called a premium, which is based on actuarial calculations of the probability of that person's suffering the loss, thereby creating a fund out of which members of this population are compensated if the risk being insured against eventuates.

Social Security taxes, however, are not true premiums because they do not reflect any actuarial calculation of risk borne by the taxpaying worker. Therefore the payroll tax is not a means of true risk pooling. Rather, it is set to cover the costs of benefits, the size of which is governed by ideological and political, not actuarial, considerations.

For example, two workers might pay the same amount of OASDI taxes all their working lives, yet one will get a benefit 50 percent higher than the other if he is married and the other is single. This has no actuarial basis; no insurance company offers annuities paying higher incomes merely because the beneficiary is married. Such arbitrary adjustments of benefits make a mockery of the idea that Social Security is insurance.

Risk transfer means that the possibility of financial loss caused by the risk's eventuating has been shifted from the individual to the insurer. An insurance company sets its premiums based on actuarial calculations of risk, and invests the revenues. If the calculations are inaccurate or the investments turn out badly, the company risks loss or even bankruptcy.

Under insurance, policyholders buy claims on the insurer, who bears a risk of loss or ruin if its resources do not suffice to meet those claims. Under Social Security, however, you "buy" a claim not on the "insurer," but on other taxpayers. And if the program's revenues are inadequate to pay benefits, Congress can, as it has in the past, simply raise the OASDI tax or lower benefits. Risk is transferred, then, not to the "insurer" but to the taxpayers or beneficiaries. The alleged "insurer" assumes no risk at all.

Furthermore, insurance companies invest premium receipts in stocks, bonds, and other instruments to build up assets to help them meet future obligations to policyholders. Social Security, by contrast, does not have this forward funding. Indeed, since it is legally barred from buying private financial instruments, forward funding for OASDI is impossible.

The retirement earnings test, which functioned as a means test, necessarily exploded the depiction of Social Security as a program of annuities. Payment of a true annuity is not conditional on the income or assets of the beneficiary.

Finally, Social Security's financial mechanism is redistribution, not insurance. Whereas under insurance annuities are paid out of a fund built up from invested premiums, under Social Security money is taxed from one group and transferred immediately to another—just as is done under any other welfare program.

***“Benefits are an Earned Right, Guaranteed by Law”***

Benefits, Social Security's promoters and defenders have declared ever since it was enacted, are received "as a matter of right," and are "an earned right," which is "guaranteed by law." Here again, Social Security's advertis-

ing is at variance with reality.

The provision in the Social Security Act's Section 1104, "The right to alter, amend, or repeal any provision of this Act is hereby reserved to the Congress," makes nonsense of Social Security's vaunted "guarantee" and "rights." Congress can reduce or even eliminate benefits. There is nothing in the law that says it can't.

The retirement earnings test necessarily means that the guarantee and earned right are conditional. If your benefit can be withheld or cut due to retirement income, your right to it is obviously not absolute, and the guarantee is meaningless. Since the retirement earnings test was present from the beginning, this inescapably means that the talk of rights and guarantees was misleading all along.

Moreover, Congress has repeatedly cut or even eliminated benefits. The 1939 Amendments removed the money-back guarantee and reduced the lump-sum death benefit to six times one's monthly benefit. They also augmented the retiree's monthly "primary insurance benefit" by an increment of one percent of the benefit computed by the benefit formula, multiplied by the number of years in which one was paid at least \$200 in wages. But in 1950 Congress reversed itself and removed this increment. It also cut the death benefit from six months to three months of benefits.

The 1950 Amendments brought most nonagricultural self-employed under Social Security. They provided, too, that no retirement benefit would be paid for any month in which a retiree earned \$50 or more in covered employment (a liberalization of the retirement earnings test). Taken together, these provisions meant that retired employees who had started their own businesses and had still received benefits (self-employment not being covered until 1950) would now lose their benefits if they earned \$50 or more in self-employment. Their "earned right" and "guarantee" had disappeared.

Although most of the 1954 Amendments expanded the program, one capped the lump-sum death benefit at \$255—at which level it remains to this day, *unadjusted for price inflation*. Also, Social Security eligibility conditions were revised so that anyone deported after August 1954 for illegal activity, conviction of a crime or subversive activity would not receive old-age benefits.

Social Security Commissioner Arthur Altmeyer admitted in the Curtis hearings that one's rights are statutory, and that there is no vested right to benefits. This was confirmed in the *Flemming v. Nestor* case (1960). On

July 7, 1956, Ephram Nestor, a Bulgarian-born alien, was deported. He had been a Communist Party member during the years 1933 to 1939. In November, 1955, he became eligible for Social Security benefits and had begun receiving them. In September 1956, his benefits were suspended. Nestor sued, arguing that old-age benefits had always been depicted as “a right of the recipient which he has earned and paid for.” He cited statements by politicians which characterized benefits as an “earned right.” Nestor won in the U.S. District Court for the District of Columbia, which held that he had been deprived of a “fully accrued property right.”

Secretary of Health, Education and Welfare Arthur Flemming appealed to the Supreme Court. On June 20, 1960, the Court decided *Flemming v. Nestor* in the government’s favor. Writing the Court’s opinion, Justice John Harlan argued that Nestor’s “right to Social Security benefits cannot properly be considered” to be of the order of an “accrued property right.” Social Security’s ability to pay benefits rests on necessarily inexact economic forecasts, hence Congress has to be free to modify the program as needed. Therefore, Harlan wrote, giving Social Security “a concept of ‘accrued property rights’ would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands,” hence Section 1104. A beneficiary “has not such a right in benefit payments as would make every defeasance of ‘accrued’ interests violative of the Due Process Clause of the Fifth Amendment,” which forbids depriving individuals of life, liberty or property without due process of law.<sup>7</sup>

Reagan’s proposed benefit cuts also illustrate that Social Security’s guarantee is illusory, that the security of benefits entirely rests on the mood of the administration and the Congress. That the Reagan cuts were defeated only shows that the beneficiary’s only real protection is the belief by politicians that cutting benefits would be political suicide. The benefit taxation, increase in the retirement age (a benefit cut) and reduction in early retirement benefits enacted in 1983, and the 1993 increase in benefit taxation, further prove that the “earned rights” and “guarantee” are fictions.

### ***“Social Security is Financed with a Trust Fund”***

Most Americans believe that Social Security is funded from a trust fund that is accumulating assets to meet future costs. It is true that the OASI and

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<sup>7</sup> *Flemming v. Nestor*, 363 U.S. 603, at 608-611.

DI accounts at the Treasury are called trust funds, that the OASI Trust fund has accumulated a large amount of government debt and that that amount is projected to continue to increase for some time. As of the end of 2006, OASDI's trust funds held \$2.0 trillion in assets. The 2007 *Annual Report* projected that under intermediate assumptions, the trust funds will peak at roughly \$2.6 trillion in 2017 (in present value). But that is as far as the resemblance to reality goes.

The truth is that the Trust Fund is a Treasury account called a “trust fund” for public relations purposes, to defuse the reserve fund controversy of the 1930s. During the Senate hearings on the 1939 Amendments, Senator Arthur Vandenberg asked Arthur Altmeyer what the purpose of the proposed trust fund was. Altmeyer replied: “Well, to allay the unwarranted fears on the part of some people who thought Uncle Sam was embezzling the money.”<sup>8</sup>

The language in the 1939 Amendments creating the Old-Age and Survivors Insurance Trust Fund was almost identical to that in the Social Security Act of 1935 which created the Old-Age Reserve Account at the Treasury. It necessarily follows that the OASI Trust Fund is simply a Treasury account.

A true common-law trust is an arrangement whereby one party (a settlor) gives his own assets to one or more trustees to be managed according to certain stipulations (terms of trust) on behalf of one or more beneficiaries. The trustees hold legal title to the property in the trust and the beneficiaries hold an equitable title to it—a claim that could be sustained in a court of law. None of these things is true of the Social Security Trust Fund. Congress is not the settlor, since it does not own the Treasuries in the “trust fund.” Nothing in the 1939 Amendments creating the OASI Trust Fund gave the Board of Trustees a legal title to anything. *Flemming v. Nestor* ruled that there is no accrued property right to benefits—and if that is so, there necessarily cannot be a property right to the assets in the OASI Trust Fund from which the benefits are supposedly paid.

Also, the “trust fund” represents no true forward funding. Social Security's surpluses have *not* been invested in productive assets with any tangible value. They are not held, as private financial reserves typically are, in stock, bonds, real estate, mortgages, etc.—assets representing real,

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<sup>8</sup> U.S., Senate, Committee on Finance, *Social Security Act Amendments: Hearings before the Senate Finance Committee on H.R. 6635*, 76th Cong., 1st sess., 1939, p. 81.

wealth-producing capital.

Instead, they have been loaned to the U.S. Treasury, which in turn uses them to finance other government spending and reduce its need to borrow from the public. In exchange, Social Security receives from the Treasury “special issue” government securities. As critics of the old-age reserve pointed out in the 1930s, these are simply claims by the government on itself. These Treasury “securities” are *nonmarketable* promissory notes backed by nothing of tangible value—”IOU nothings” that cannot be used in any market transaction whatsoever. They have no price, and therefore no value.

When the time comes to use the phantom “surplus” to pay benefits, Social Security will present its “IOU nothings” for payment, and the Treasury will have to extract the money from the private economy, through higher taxes or borrowing from the public. And borrowing from the public will entail higher interest costs, a legally binding claim on federal revenues. The Social Security “trust fund’s” only real assets, then, are the government’s power to tax and the public’s willingness to be taxed.

However, as AIER warned presciently back in 1939, long before Social Security’s tax burden on the young exploded to what were then unimaginable levels:

The truth of the matter is that we (citizens of voting age today) are attempting to provide for *our own* old age at the expense of our children and grandchildren. We would not dream of assuming one-third of the burden that we are planning to place on the shoulders of those too young to know what we are doing, and others yet unborn...We are assuming that our children and grandchildren will be peculiarly eager to shoulder burdens which were not of their making.<sup>9</sup>

This being so, it is not true that the accumulation of the Trust Fund since 1983 represents a shift from pay-as-you-go funding to “partial advance funding” or “partial funding,” as is often claimed. Social Security is not merely *underfunded*, as the long-term actuarial deficits indicate, it is *unfunded*. An asset with no market value cannot “fund” anything. It necessarily contributes *nothing* to its holder’s ability to meet future obligations.

Another way to see this is to ask yourself, Suppose the OASDI “trust

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<sup>9</sup> “Whither Social Security?,” in American Institute for Economic Research, *Weekly Bulletin*, January 23, 1939, pp. 22-23.

fund” did not exist? Then Congress would have to cover Social Security’s future revenue shortfall by raising the payroll tax. By how much? By enough to cover the shortfall, of course—that is, by exactly the same amount as it would have to increase other taxes or borrowing from the public to pay off the phantom assets presented to cover the shortfall.

And regardless of how the money was raised, whether by higher payroll taxes, by higher general-revenue taxes or by higher borrowing, it would necessarily come from the same source, the only possible source: the private sector. The burden on the economy and the taxpayer would be exactly the same. The only difference would be the mechanism of imposing the burden. In other words, the “trust fund’s” existence not only makes no true contribution to funding future obligations, its presence or absence makes no economic difference whatsoever! If Congress abolished the “trust fund” tomorrow and wrote off its “assets,” Social Security’s ability to pay the benefits of baby boomers would be unaffected.

***“Social Security’s Trouble is that  
Congress is Robbing the Trust Fund”***

If there is a Social Security Trust Fund, and if it holds nothing but unmarketable IOUs, it follows, in the minds of many, that a nefarious Congress has robbed the Trust Fund and left an IOU, and that if only that had not happened, Social Security would be sound. This too is nonsense.

If there is no true trust fund, then it necessarily follows that there has been no trust fund robbery. Congress cannot rifle a trust fund that does not exist. Moreover, the Social Security Act mandated from the beginning that revenues above those needed to pay a year’s benefits were to be used to buy special unmarketable Treasuries issued for this purpose, with the money itself thereby being made available to the Treasury for general use.

It is simply an artifact of accounting that Social Security surpluses help offset on-budget deficits and thereby make unified budget deficits smaller. Crediting the Social Security Treasury accounts (trust funds) with unmarketable Treasuries in amounts equivalent to OASDI revenues received, and debiting them by amounts equal to benefits paid, are routine operations of the Treasury, not consequences of a decision by Congress to steal Social Security money.

And, as we shall see, the coming Social Security crisis is being driven by demographics. That the OASDI Trust Fund contains unmarketable Treasury

debt has nothing to do with it. Indeed, as noted above, the “trust fund’s” existence or nonexistence makes no difference for Social Security’s ability to meet its future obligations.

***“Social Security is a Defined-Benefit Pension Plan”***

In recent years Social Security’s partisans have taken to describing it as a defined-benefit pension plan—that is, a plan which specifies the size of the pension benefit you will get upon retirement. The analogy looks plausible at first glance: Social Security does have a precise formula for determining an individual’s basic monthly benefit, and specifies how that amount can be increased or decreased under various circumstances (*e.g.*, retiring before or after the normal retirement age, or having dependent children). This enables the specific amount of one’s retirement benefits to be calculated in advance, as Social Security does in the benefit statements it sends to taxpayers. However, the analogy collapses upon closer inspection.

For one thing, pension plans, like insurance policies, are characterized by forward funding. While pension fund managers have latitude in their choice of assets to fund their reserves, such assets must be of “high quality.” At the very least, any sound pension fund requires that the actuarial reserves of the pension program have *at least some market value*. This, of course, is precisely what is *not* true of Social Security.

Despite its “trust fund” trappings, and the large amounts of unmarketable Treasury securities accumulating in the “trust fund,” Social Security remains a pay-as-you-go system. Because the funds paid in to Social Security are not invested in any meaningful way (but transferred immediately to beneficiaries or used to finance other Federal programs), they represent not a stream of monies going into a national defined-benefit pension plan, but simply a huge transfer of wealth, largely from current workers to current retirees.

A defined-benefit pension plan is a binding obligation on the employer in question. Employers are legally liable for the specified dollar benefits owed to employees. This is why companies must fund defined-benefit plans, and why the funding must consist of “high-quality” assets. Pension laws require that a minimum level of funding be maintained.

By contrast, the purported “defined benefits” specified by Social Security law are no such legally binding obligation set in stone. Section 1104 enables Congress to redefine benefits at will. They can be and indeed

have been cut and even eliminated as well as increased. Social Security’s “defined benefits” are defined as of right now. A malleable defined benefit is a contradiction in terms.

The analogy of Social Security to a defined-benefit pension plan has a special irony and inappropriateness because it is *illegal* for an employer to finance a pension plan on a pay-as-you-go basis. The first pension plans did in fact operate this way, but this meant that if the company went out of business, retired employees received no further benefits, there being nothing to pay them with. This led employers to set up separate trust funds for paying pensions, a practice the tax code encouraged by allowing employers to treat their contributions to “qualified” pension funds as a deductible expense. These contributions were (and are) usually not taxed as income to employees either. The Employee Retirement Income Security Act (ERISA) of 1974 *requires* private employers offering pension plans to put cash into a separate trust or insurance contract solely for paying benefits. Private pension plans, in other words, are explicitly *forbidden* to operate the way Social Security does—which necessarily makes the analogy untenable.

### ***“Social Security is a Savings System”***

From the beginning, Social Security has had an account for each taxpayer, which gives the appearance of payroll tax money accumulating on the individual’s behalf, as it would in a savings bank. But these “accounts” are merely records of tax payments, and contain no funds. The taxes are spent immediately as transfers to beneficiaries or on other federal programs. And far from being a means of savings for old age, Social Security taxes make it more difficult for individuals to save for their own retirement.

Furthermore, the federal government’s inability to forward fund Social Security means that *Social Security cannot save*. “Trust fund” surpluses not returned to taxpayers must be spent in some way in exchange for internal IOUs.

### ***Reality Check: What Social Security Does—and Does Not Do***

Let us summarize by sorting out what Social Security does from what it does not do. Social Security pays transfers based on a presumption of need, intended to prevent poverty arising from various conditions such as retirement, death of a breadwinning parent or spouse, or disablement of oneself or one’s parent.

In so doing, it provides the bulk of retirement income of many elderly persons. It accounts for more than half of all income for 66 percent of the beneficiaries; contributes 90 percent or more of all income for one-third of the beneficiaries, and is the only source of income for 21 percent of them. Increases in benefit levels and coverage have caused the share of persons aged 65 or older who are poor to decrease from 35.2 percent in 1959 to just 9.8 percent in 2004. Social Security has indeed, as its partisans point out, greatly reduced old-age poverty.

Moreover, since its benefits are augmented yearly with a COLA, it does provide protection against price inflation, which many private annuities and pensions do not. One of the greatest risks of a defined-benefit plan is the loss of benefit value through price inflation. Defined-benefit plans usually offer only partial or *ad hoc* indexing (*i.e.*, benefits are raised only when the level of a company's retirement benefits become an embarrassment that demoralizes the company's current employees).

Social Security, however, does *not* contain any real guarantees, and therefore provides *no* true security. First, Section 1104 vitiates any real guarantee. Second, the insecurity Social Security supposedly eliminates is in fact inescapable. Social Security was depicted as providing a sure, certain benefit, as opposed to the insecurity of stocks (which crashed in 1929) or savings banks (which failed by the thousands in the 1930s). This was a source of its powerful appeal in the 1930s, when many Americans craved deliverance from economic insecurity.

Social Security *seemed* to deliver on its promise of security in the 1940s, 1950s and 1960s. This, however, was due not to the nature of Social Security itself, but to the benign context in which it operated—low inflation, cheap energy, prosperity, a stable dollar tied to gold via the Bretton Woods system, a large and growing taxpayer population—which meant that Social Security was not under threat from external forces.

However, OASDI's recurring financial crises of the 1970s demonstrated that the insecurity spawned by economic fluctuations had not been escaped after all: serious inflation and recession drastically weakened Social Security's cash flow, and to meet this problem Congress had to modify taxes and benefits, which meant that individuals again faced insecurity, in the form of the prospect of loss through higher taxes and/or reduced benefits. This prospect was realized by taxpayers via the tax increases of 1977 and 1983, and by current and future beneficiaries via the benefit cuts enacted in 1983.

Whereas in private saving and investment the individual faces economic insecurity directly, under Social Security this insecurity is borne indirectly through the vicissitudes of politics and policymaking.

It bears emphasis that Section 1104 is not wicked, perfidious or unreasonable. For one thing, reservation of power is routine in legislation. For another, Congress simply must leave itself some way of modifying legislation such as Social Security to meet changing circumstances, so as to keep the government solvent and to prevent the government's programs from breaking the economy. No responsible Congress would lock itself into a rigid position about Social Security in the face of fiscal crisis, leaving taxes and benefits unchanged. Something would have to give.

In the past, the uncertainty in Social Security was borne mostly by taxpayers, whose taxes were repeatedly raised to cover rising costs. But occasionally beneficiaries too had the rules rewritten to their disadvantage, and further benefit reductions are all but inevitable.

Also, Social Security does *not* eliminate the need to save or invest for one's old age. Social Security was never intended fully to replace your preretirement labor income or to enable you to continue to enjoy the standard of living you have while working. To their credit, Social Security's administrators recognized this by depicting Social Security as a floor of protection, upon which the individual would build with his own saving and investing. Another image they used was the three-legged stool, Social Security being one leg, your pension from your job being the second and your own saving and investing being the third.

In short, Social Security is *not* an insurance, annuity, savings or defined-benefit pension plan. It is an income redistribution program, plain and simple.



### III.

#### THE SOCIAL SECURITY CRISIS

**D**ESPITE its growing trust fund, Social Security remains, as we have seen, an unsustainable pay-as-you-go system—*i.e.*, a Ponzi scheme. Just as Mr. Ponzi’s scheme collapsed when the stream of new investors dried up, Social Security will become unsustainable if the pool of new entrants (taxpaying workers) no longer grows rapidly enough to pay the program’s benefits. Given current demographic trends, annual cost will begin to exceed tax income in 2017.

A reminder is in order that the Social Security actuaries’ projections of future costs, revenues and so on, and dates of future events such as trust fund exhaustion, are *projections*, heavily dependent on the actuarial assumptions underlying them. So, although we will refrain for brevity’s sake from cluttering the text with such qualifiers as “roughly” and “approximately” every time a projected figure or date is used, these figures and dates should

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Table 1: **Total Fertility Rate, Number of Covered Workers and OASDI Beneficiaries (Thousands), and Workers Per Beneficiary, Selected Calendar Years 1950-2080\***

<i>Calendar year</i>	<i>Total fertility rate</i>	<i>Covered workers</i>	<i>OASDI beneficiaries</i>	<i>Workers per beneficiary</i>
1950	3.03	48,280	2,930	16.5
1960	3.61	72,530	14,262	5.1
1970	2.43	93,090	25,186	3.7
1975	1.77	100,200	31,123	3.2
1980	1.82	113,649	35,117	3.2
1985	1.82	120,575	36,650	3.3
1990	1.82	133,559	39,471	3.4
1995	1.82	141,446	43,107	3.3
2000	1.82	155,295	45,166	3.4
2005	1.82	159,081	48,133	3.3
2010	1.82	167,664	52,942	3.2
2020	1.82	176,602	68,723	2.6
2030	1.82	182,708	83,982	2.2
2040	1.82	189,189	91,483	2.1
2050	1.82	195,597	95,607	2
2060	1.82	201,387	100,999	2
2070	1.82	207,208	106,420	1.9
2080	1.82	212,880	111,716	1.9

\* 2010-2080 under intermediate actuarial assumptions. Source: 2007 OASDI *Annual Report*.

be not be regarded as precise.

***Demographic Roots of the Social Security Crisis***

The high fertility period of 1945-65, known as the baby boom, was followed by a fertility collapse. The fertility rate fell and remains below the replacement rate of 2.1 lifetime births per woman. The taxpayer population born after 1965, who will pay benefits for the huge baby-boom generation when it starts retiring about 2010, will therefore grow more slowly than the beneficiary population it will support. The ratio of Social Security taxpayers (covered workers) to beneficiaries will decline accordingly. While 3.3 taxpayers support every beneficiary today, under Social Security’s intermediate actuarial assumptions, this ratio falls to 2.6 in 2020, and to just 2.0 in 2050. Moreover, the fertility rate is projected to remain below replacement in future decades (see Table 1 on previous page).

Another important demographic root of Social Security’s financial troubles is rising longevity. Obviously, the longer people live, especially after they have gone on Social Security, the longer they will be collecting benefits and the higher will be Social Security’s costs. Life expectancy for men born in 1940 was 61.4 years. That is, most men were expected to die before collecting any Social Security benefits. Those who did reach 65 in 1940 were expected to live only another 12 years. Women were not much better off.

By 2000, both life expectancy at birth and life expectancy at age 65 were much higher for both sexes. Under intermediate assumptions, baby boomers reaching age 65 will live much longer than earlier generations of beneficiaries (see Table 2). This, and their increased numbers, means the boomers will put a colossal burden on Social Security.

Current law leaves the tax rate at the same level in the future as it is

**Table 2: Life Expectancies Selected Calendar Years, 1940-2060\***

<i>Calendar year</i>	<i>At birth</i>		<i>At age 65</i>	
	<i>Male</i>	<i>Female</i>	<i>Male</i>	<i>Female</i>
1940	61.4	65.7	11.9	13.4
1990	71.8	78.9	15.1	19.1
2000	73.9	79.2	15.9	19
2020	76.7	80.7	17.4	19.7
2040	78.6	82.4	18.5	20.8
2060	80.3	83.8	19.6	21.8
2080	81.9	85.1	20.6	22.8

\* 2000 preliminary; 2020-2080 intermediate assumptions. Source: 2007 OASDI Annual Report.

now: 12.4 percent of taxable payroll. With fewer workers per beneficiary paying taxes at the same rate, and with beneficiaries not only exploding in number (more than doubling between 2000 and 2040) but also living longer, the result is obvious: costs will eventually exceed revenues. Social Security will have to “cash in” the federal debt in its Trust Fund to cover its shortfall. Under intermediate assumptions, OASDI’s actuaries project that the combined OASDI Trust Fund will be exhausted in 2041. Put another way, in 2041 Social Security will not be able to pay full current-law benefits on time.

That is what most Americans think constitutes the crisis in Social Security: depletion and exhaustion of the Social Security Trust Fund and the program’s consequent inability to pay full benefits on schedule. This is partly because most people, especially current retirees and baby boomer taxpayers, look to Social Security for retirement benefits both as an income source and a payback for the Social Security taxes they paid over their working lives. So, understandably, Social Security’s ability to deliver on its benefit promises is an urgent concern of theirs. But the focus on the depletion date is also a consequence of the program’s structure, which is funded with a payroll tax and operating a so-called “trust fund.” This leads most Americans, especially politicians and the media, to focus on the health of the Trust Fund.

The Board of Trustees’ *Annual Report* gives, among other things, the projected date of trust-fund exhaustion under intermediate actuarial assumptions. If this date moves farther into the future, as it has in recent years, it is widely taken as a sign that Social Security’s financial outlook is improving.

**Table 3: History of Social Security Trustees’ Estimates**

<i>Report Year</i>	<i>Year When Costs Exceed Tax Revenues</i>	<i>Year When Trust Fund is Exhausted</i>
1997	2012	2029
1998	2013	2032
1999	2014	2034
2000	2015	2037
2001	2016	2038
2002	2017	2041
2003	2018	2042
2004	2018	2042
2005	2017	2041
2006	2017	2040
2007	2017	2041

Source: Trustees Reports, various years.

Thus, when the 2002 *Annual Report* put the projected date of exhaustion at 2041, three years later than the date in the 2001 *Annual Report*, the *New York Times* reported that “The financial outlook for Social Security and Medicare improved in the last year...”<sup>10</sup>

Likewise, Social Security’s partisans cite the distant and receding exhaustion date to argue that Social Security is sound, making radical reform unnecessary. Congressman Robert Matsui (D-CA) called the 2002 *Annual Report*’s projection “especially welcome. It clearly shows that Social Security is not facing the crisis that opponents claim...those who claim that [it] is collapsing are misleading the public.” Privatization, Matsui concluded, is “unnecessary and dangerous.”<sup>11</sup> Likewise, economist Robert Kuttner wrote that “Social Security is healthier than previously thought...the system is fine until 2041.” Like Matsui, Kuttner used this to dismiss reform proposals; privatizers’ timing, he crowed, “could hardly be worse.”<sup>12</sup>

***The Real Crisis: Social Security’s Unaffordability***

Unfortunately, this national fixation on the exhaustion of Social Security’s

<sup>10</sup> “Report on Social Security Adds 3 Years to Fund’s Life,” *New York Times*, March 27, 2002.

<sup>11</sup> Robert T. Matsui, “Trustees’ Report Shows Social Security’s Financial Health Improving,” News Release, March 26, 2002, [www.house.gov/matsui](http://www.house.gov/matsui).

<sup>12</sup> Robert Kuttner, “Social Security’s happy secret,” *Boston Globe*, April 3, 2002.

**Table 4: Social Security’s Collapsing Cash Flow Surplus,  
Calendar 2007-2025\***  
(dollar amounts in billions)

<i>Calendar year</i>	<i>Total income</i>	<i>Minus Interest income</i>	<i>Equals Cash inflow</i>	<i>Minus Total outgo</i>	<i>Equals Cash flow surplus or deficit</i>	<i>Total surplus or deficit</i>	<i>Cash flow surplus as % total</i>
2007	783	109	674	594	80	189	42.3%
2010	935	144	791	694	97	241	40.4%
2015	1222	220	1002	966	36	256	14.1%
2016	1284	235	1049	1034	15	250	6.0%
2017	1347	250	1097	1106	-9	241	--
2018	1413	265	1148	1182	-34	231	--
2019	1479	280	1199	1264	-65	215	--
2020	1546	294	1252	1349	-97	197	--
2025	1887	334	1553	1833	-280	54	--

\* Intermediate actuarial assumptions. Source: 2007 OASDI *Annual Report*, Office of the Actuary.

Trust Fund is leading us seriously astray in two respects. First, the accumulation of surpluses in the Trust Fund gives a badly exaggerated notion of Social Security's ability to pay its way. Not only is the unmarketable federal debt in the Trust Fund useless as a means of forward funding, so that the Trust Fund's presence or absence makes no economic difference; the large and growing annual surpluses that Social Security's actuaries project to continue for the next several years mask, as Table 4 shows, a collapse in Social Security's cash flow surplus, *i.e.*, the surplus of tax revenues over costs. Even now, less than half of Social Security's annual surplus is an actual revenue surplus; the rest is interest, paid in the form of additional unmarketable debt. Though the dollar amount of the surplus keeps growing, Social Security's cash flow will weaken until the end of 2016, when the payroll tax will just cover costs.

Beginning in 2017, Social Security will start running growing cash deficits, which means that some of the interest income accruing each year will have to be used to cover the shortfall. In other words, even while the trust fund is still growing, and over two decades before its projected exhaustion, Social Security will be making substantial and rapidly growing claims on the general funds of the Treasury, resulting in higher taxes or borrowing from the public. The fixation on the trust fund exhaustion obscures this weakness in Social Security's cash flow and the serious fiscal consequences.

Second, fixation on the trust fund exhaustion date is dangerously misleading observers about the nature of the coming crisis. The exhaustion date is an important piece of programmatic information, an indicator of Social Security's ability to carry out its mission: paying old-age, survivors and disability benefits to those qualified for them. But its significance is strictly internal to the program. What matters from an economic and fiscal standpoint are Social Security's relationships to the budget and to the economy, *i.e.*, its cost and affordability. The exhaustion date says nothing about these all-important questions.

The crucial indicator for fiscal and economic purposes is Social Security's cost—which, of course, is its projected outgo. This tells us what it will cost to honor Social Security's benefit obligations mandated by current law (see Table 5 on next page). As we have already established, which specific mechanism is used to pay these costs—payroll taxes, or liquidating trust fund assets and getting monies from general revenues and/or borrowing from the public—is immaterial. All these methods draw resources from

the same source: the productive private economy.

Cost figures in current-dollar terms are self-explanatory. Cash deficit data in current dollars reveal the magnitude of Social Security's claims on the Treasury as its costs exceed its revenues. Measuring costs and cash deficits as shares of GDP indicates the size of Social Security's claims on the economy.

Under intermediate actuarial assumptions, Social Security will cost \$594 billion in 2007 (4.3 percent of GDP) and \$694 billion (4.3 percent of GDP) in 2010. As baby boomers retire, Social Security's cost explodes, more than doubling in just ten years, to \$1.349 billion (5.3 percent of GDP) in 2020. Social Security's rising share of GDP means that its claims on the economy will be growing faster than the economy that will have to meet them.

As costs start outrunning revenues, Social Security's cash flow surplus becomes a deficit. Meanwhile the vaunted trust fund more than doubles from 2007 to 2025, and its exhaustion, slated for 2041, is still years away. To Social Security partisans, this indicates that all's well, even as costs are soaring—which reveals the exhaustion date's uselessness for fiscal and economic purposes.

In 2040, a year before the distant exhaustion date that Social Security's partisans find so reassuring and deem a reason not to reform Social Secu-

**Table 5: The Economic Irrelevance of Trust Fund Exhaustion: OASDI Costs, Revenues, Cash Surpluses/Deficits, and Assets (billions current dollars) and Years to Exhaustion 2007-2055, Intermediate Assumptions**

Calendar Year	Cost (Outgo)	Tax income	Cash Surplus/Deficit	Trust Fund Assets	Years till	Cost as % of GDP	Surplus/Deficit as GDP
					Trust Fund Gone		
2007	594	674	80	2,237	34	4.3	0.6%
2010	694	791	97	2,917	31	4.3	0.6%
2015	966	1,002	36	4,210	26	4.8	0.2%
2020	1,349	1,252	-97	5,344	21	5.3	-0.4%
2025	1,883	1,553	-330	5,942	16	5.8	-1.0%
2030	2,421	1,921	-500	5,541	11	6.2	-1.3%
2035	3,089	2,375	-714	3,739	6	6.3	-1.5%
2040	3,834	2,935	-899	222	1	6.3	-1.5%
2045	4,716	3,622	-1094	--	--	6.2	-1.4%
2050	5,815	4,459	-1356	--	--	6.2	-1.4%
2055	7,217	5,484	-1733	--	--	6.2	-1.5%

Source: 2007 OASDI Annual Report.

rity, projected costs will be \$3.834 billion, about six times 2007's figure. The cost in 2040 will be 6.3 percent of GDP, almost 50 percent bigger than 2007's share. In that same year, OASDI's projected cash deficit will near a trillion dollars.

Once Social Security starts running cash deficits, unless Congress raises general revenue taxes or cuts on-budget spending, these cash deficits will translate into unified budget deficits, quickly running into hundreds of billions of dollars a year. By 2025 covering Social Security's cash deficit will cost roughly one percent of GDP.

Trust fund assets peak at about \$6.0 trillion in 2026. When the trust fund is actually drawn down, the cash deficits will rise to over a trillion dollars a year. Exhaustion in 2041 means the Treasury must raise \$6.0 trillion in just 15 years, meaning taxing or borrowing over one percent of GDP *every year*, to help finance *one* program.

Financing these huge Social Security deficits will put an enormous burden on the Treasury and the economy. This inevitably will impair investment and employment, which in turn will weaken the economy's ability to carry the soaring burden of Social Security costs. This will weaken Social Security's cash flow, worsening Social Security's cash deficits, and setting off a vicious circle of rising federal borrowing.

The focus on the exhaustion date, then, is mistaken. The real crisis is not that Social Security's trust fund will be exhausted, but that Social Security will cost more than we can afford, *whether its assets are exhausted or not*.

Around 2010, the amount by which Social Security taxes exceeds benefits paid each year will peak at around \$100 billion. Thereafter this amount, which has been available to the politicians to spend on other federal programs, will diminish. By 2017 it will become negative—other tax revenues or borrowing will be needed to pay benefits. By 2027 or so, some of the unmarketable securities in the trust fund will begin to be redeemed, which will mean that even more general revenues or borrowing will be needed, if only to pay interest to genuine lenders instead of crediting it to the trust fund. In other words, long before the exhaustion date, Social Security will be bleeding the budget and the economy.

After the trust fund is exhausted, if payroll taxes are raised to eliminate cash deficits and make Social Security self-financing again, this will entail extremely high payroll tax rates. By inspection, the required tax rates listed

in Table 6 will initially be at least one-third higher than the current-law rate, then rise still higher. Oppositely, if Social Security taxes are not increased, benefits would have to be cut by one-third if the system is to remain solvent. Is the prospect of such a drastic and catastrophic choice somehow acceptable because it is many years in the future?

***Intergenerational Inequity***

In the past, Congress responded to Social Security’s earlier financial crises by raising taxes and cutting benefits, with the benefit cuts engineered to fall mostly on future beneficiaries rather than those already receiving benefits when the legislation was enacted. In so doing, Congress greatly exacerbated a phenomenon intrinsic to Social Security: succeeding generations of beneficiaries receive less and less in relation to the taxes they and their employers paid.

The initial generation of beneficiaries paid very small amounts in taxes for only a short time before collecting their benefits. Some enjoyed fantastic windfalls. The most famous example was one Ida Fuller, who paid \$22 in Social Security taxes, came out ahead with her first benefit check of \$22.54, and ultimately received over \$20,000 in benefits thanks to her longevity. The self-employed and elderly brought under Social Security in 1950 also received windfalls.

However, as the program matured, the beneficiary population grew, and benefits became more generous, later generations spent their entire work-

**Table 6: Social Security Payroll Tax Rates Needed After Trust Fund Exhaustion, With No Benefit Cuts\***

(as percentage of taxable payroll)

<i>Calendar year</i>	<i>OASDI cost rate</i>	<i>Minus benefit tax rate</i>	<i>Equals required tax rate</i>	<i>Minus current law tax rate</i>	<i>Equals increase in tax rate</i>
2045	17.22	0.85	16.37	12.4	3.97
2050	17.26	0.86	16.40	12.4	4.00
2055	17.43	0.88	16.55	12.4	4.15
2060	17.67	0.89	16.78	12.4	4.38
2065	17.89	0.91	16.98	12.4	4.58
2070	18.10	0.92	17.18	12.4	4.78
2075	18.29	0.93	17.36	12.4	4.96
2080	18.50	0.95	17.55	12.4	5.15

\* Intermediate assumptions. Source: 2007 OASDI Annual Report.

ing lives paying higher and higher taxes. Both the payroll tax rate and the maximum taxable income increased enormously. It necessarily followed that for each succeeding generation, total benefits exceeded lifetime tax payments by a smaller margin.

Obviously, the first generation of beneficiaries received large intergenerational transfers: virtually all of their benefits were paid for by the taxes of younger workers. Such transfers obtain whenever benefits exceed payroll taxes plus accrued interest, all expressed in present-value terms.<sup>13</sup> Expressed as a proportion of total benefits for cohorts of age 65 retirees from 1940 to 1970, the ratio of such transfers to benefits dropped from about 98 percent in 1940 to 68 percent in 1970. The ratio for females receiving benefits on their own decreased from 99 percent to 80 percent over the same period. These numbers imply that a male retiree in 1940 contributed only two percent toward the benefits he received, while a male retiree in 1970 contributed 32 percent. The corresponding figures for females were one percent and 20 percent, respectively.<sup>14</sup>

The tax increase of 1977 and the tax increase and future benefit cuts of 1983 necessarily greatly worsened this situation. In the two decades since 1983, the putative returns on Social Security taxes for various generations of Social Security taxpayers have been calculated in numerous studies using different methods. One of the most rigorous of these, by Dean Leimer of the Social Security Administration, employed calculations of the internal rate of return (IRR)—that is, the discount rate that equates the present value of benefits with the present value of taxes. For an individual worker, the IRR may be viewed as the interest rate that he would have to earn on annual savings in amounts equal to Social Security taxes paid, in order to be able to withdraw amounts in retirement equal to Social Security benefits received, leaving a balance of zero at the end of his life. Individuals' experiences vary greatly, however, not only because some die before ever collecting any benefits while others enjoy long retirements, but also because Social

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<sup>13</sup> More rigorously, the expected present value (PV) of transfers is the difference between the PV of lifetime payroll tax contributions and the PV of expected benefits, all adjusted for survival probabilities. See Michael J. Boskin, *Too Many Promises: The Uncertain Future of Social Security* (Homewood, IL: Dow Jones-Irwin, 1986), p. 187, footnote 14.

<sup>14</sup> See Douglas R. Munro and Donald O. Parsons, "Intergenerational Transfers in Social Security," in *The Crisis in Social Security: Problems and Prospects*, ed. Michael J. Boskin (San Francisco, CA: Institute for Contemporary Studies, 1977), pp. 65-86.

Security benefits vary greatly depending on whether the individual is or was married or has dependents in retirement. All this affects individual IRRs. So, in examining Social Security’s performance, analysts usually focus on aggregate taxes and benefits.

Leimer calculated inflation-adjusted IRRs on the taxes paid and the benefits received by persons born in every year since 1875. Presumably all of the earliest “birth cohorts” are now dead, and there is no doubt, aside from statistical error, about what they paid and what they received. However, for later cohorts, the calculations increasingly reflect estimates and projections. For those now collecting benefits, the IRR calculation reflects estimated mortality, i.e., how long will they continue to collect? For those now working, the calculation also reflects estimated future changes in the national average wage (which will affect their benefits), as well as future levels of employment and labor force participation (which will affect aggregate taxes).

Table 7 summarizes Leimer’s results.<sup>15</sup> The IRR was very high for the first birth cohort but fell rapidly as Social Security matured. These results assume the tax and benefit provisions of present law. However, Social Security is in long-term actuarial deficit, and changes based on tax increases and benefit cuts are inevitable. Accordingly, Leimer did a second set of IRR calculations to determine the effect on the IRR of a series of increases in the payroll tax, beginning in 2020, designed to bring Social Security into actuarial balance over the projection period through the year 2150. These results appear in the “Balanced budget” column. The early birth cohorts, no longer paying payroll taxes by 2020 by virtue of death or beneficiary

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<sup>15</sup> Source: Dean R. Leimer, “A Guide to Social Security Money’s Worth Issues,” *Social Security Bulletin*, vol. 58, no. 2 (Summer 1995), p. 12.

**Table 7: Inflation-Adjusted Internal Rates of Return Under OASDI, Selected Birth Cohorts, as Estimated by Leimer**

(in percent)

Birth cohort	—Rate of return—		Birth cohort	—Rate of return—	
	Present law	Balanced budget		Present law	Balanced budget
1876	36.5	36.5	1975	1.9	1.8
1900	11.9	11.9	2000	1.7	1.5
1925	4.8	4.8	2025	1.7	1.2
1950	2.2	2.2	2050	1.7	0.9

status, are unaffected; but the younger cohorts have their IRRs depressed even further by the tax increases. For those born in 2050, the IRR becomes just 0.9 percent.

Of course, the farther analysts project into the future, the more likely their projections are to be upset by unforeseen events. The estimated IRRs in the table thus must be regarded as highly speculative. At best, they tell us what may happen under economic, demographic and policy assumptions that the author deemed reasonable. If, for example, future population growth and participation rates fell only slightly short of the assumed levels, the IRRs could eventually turn negative. Such a trend could be exacerbated if payroll tax increases drive more workers into the underground economy.

Methods of determining Social Security's "money's worth" vary. Some analysts measured money's worth in terms of "payback period": an estimate of how long it takes a beneficiary or beneficiary couple to recover in benefits the Social Security taxes they paid. If the payback period is less than their expected remaining lifetimes after starting to collect benefits, Social Security is a good deal for them; otherwise not. Some studies simply calculated ratios of the present value of benefits to the accumulated value of taxes if the taxes had earned interest at the rate paid on government bonds. A ratio greater than one means that the workers in question come out ahead; a ratio equal to one means they just break even; and a ratio less than one means Social Security is a bad deal for them.

Because interest on government bonds can fluctuate significantly, other analysts employed the IRR. Some studies included only retirement benefits in their calculations; others took into account Social Security's survivor and disability benefits (which, incidentally, involve features such as indexing that are difficult or impossible to purchase privately). Regardless of the method employed, the findings are remarkably consistent across the studies: the later a demographic cohort's birth year, the lower the putative returns on Social Security taxes paid. By some calculations, Americans born in 1990 or 2000 will receive negative returns—that is, under current law, these young Americans will pay more into Social Security in taxes than they will ever receive in benefits.<sup>16</sup>

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<sup>16</sup> Besides Leimer's article, another useful discussion may be found in Sylvester J. Schieber and John B. Shoven, *The Real Deal: The History and Future of Social Security* (New Haven and London: Yale University Press, 1999), pp. 218-228.

Needless to say, the foregoing estimates are based on the total taxes paid and the total benefits received or to be received by the persons born in a given year. The experiences of persons within an age cohort can, of course, vary markedly. Much of this variation reflects differences in how long individuals live, their marital status, etc. Because of the skewing of benefits toward low-wage persons, the putative returns for higher-income persons are likely to be much lower (perhaps even negative for those retiring in 2000 and later years) than indicated in the table above.

However, while money's-worth analyses help make clear Social Security's deteriorating outlook and rising costs, and underscore that people might do better by investing privately the monies taken from them in payroll taxes, they are highly misleading. They feed the mistaken notion that Social Security is an investment plan and that benefits are a return of a worker's taxes.

The fact is that workers' taxes have never been invested. There is no "rate of return," because there is nothing on which to earn a return! The main message of money's-worth analyses is not that people are likely to receive relatively little in relation to their taxes paid, but that the burden on workers of supporting the program is greater now than in years past, and that it will increase as the ratio of workers to beneficiaries shrinks.

### *The Political Crisis*

One source of Social Security's enduring popularity is the belief that it is a "good deal" not only for the poor but for the American middle class. However, the deteriorating relationship between one's tax payments into Social Security and one's benefit receipts from it has affected public attitudes toward the program. People are increasingly questioning whether they will get their "money's worth" from Social Security.

Current retirees suspect (correctly) that they are not getting as good a "deal" as earlier generations of retirees. Many workers, especially younger ones, doubt that the benefits they can expect to receive in the future will be worth as much as the value of their payroll tax payments.

All this has affected Social Security's politics and policymaking in important ways. It has greatly increased younger Americans' discontent with Social Security and made them highly resistant to another increase in Social Security taxes, which in turn makes another rescue of Social Security based on massive tax increases highly unlikely, and constrains policymak-

ing accordingly. It has generated a powerful and analytically sophisticated critique of Social Security on grounds of intergenerational inequity. Finally, the widespread awareness among the young of that intergenerational inequity, of their high tax burden and of the much better yields available from investment in private securities, has been a major force driving demands for “privatization” of Social Security.

At the same time, dependence on Social Security for much or most of one’s retirement income is, as we have noted above, widespread. Most Social Security beneficiaries continue to opt for early retirement. Partly because of the now-formidable income confiscation by the Social Security tax itself, many baby boomers have done little to accumulate savings and investments for their old age. Moreover, the poor performance of the stock market between 2000 and 2002 badly reduced what investments for retirement they managed to make. It all adds up to continued high dependence on Social Security in future decades, meaning massive resistance to any attempt to reduce benefits.

Furthermore, many people subscribe to the Social Security myths examined in the previous chapter. These firmly-held delusions make many Americans refuse to countenance benefit cuts.

The policymakers’ options are narrowing. With virtually all of the labor force already participating, the potential for capturing more revenues by expanding Social Security coverage has been exhausted. Raising the maximum income subject to tax also raises future benefit costs because benefits are also based on income up to this ceiling. The only revenue-raising option left is increasing the payroll tax rate. The rate increases necessary to restore Social Security’s solvency after trust fund exhaustion would, as we saw, be massive—and opinion polls repeatedly disclose widespread opposition to another payroll tax increase.

The fate of Reagan’s 1981 proposals to cut benefits indicates the likely outcome of any future attempt explicitly to cut benefits for current beneficiaries. Tellingly, the benefit cuts enacted in 1983 were either pushed into the future or done indirectly via benefit taxation. Unfortunately, cutting benefits for generations born *after* the baby boom will do *nothing* to reduce the cost of benefits for the boomers themselves. And the projected collapse of Social Security’s cash flow and exploding deficits already factors in existing benefit taxation. So the crucial task of reducing Social Security’s costs to affordable levels entails the riskiest measure of all: substantial explicit

reductions in benefits for current and imminent retirees.

Clearly, any attempt to deal with the baby-boomer retirement costs through taxes and benefit cuts has the potential for a classic political confrontation. Benefit cuts will frighten and displease both today's beneficiaries, many of whom will still be alive in the next two decades, and the boomers, among whom dependence on Social Security will also be widespread. Leaving benefits essentially untouched and trying to raise revenues enough to pay for them will probably generate discontent among younger taxpayers, who are already keenly aware of their burden. Spreading the pain between the old and the young by mixing somewhat smaller benefit cuts and somewhat smaller tax increases will merely spread the fear and anger almost everywhere. The political drawback of near-universal participation in Social Security is that nearly everybody has something, in many cases a great deal, to lose if taxes are raised or benefits cut.

Social Security's unaffordability therefore risks a political crisis without precedent in our history. As a coerced redistributive transfer, Social Security is a zero-sum game: the beneficiary's gain is the taxpayer's loss. The magnitude of the potential financial crisis, and the size of the sacrifices that will be necessary to cope with it, mean that sparing either generation will impose genuine hardship on the other. The crisis thus has the potential to pit generation against generation. The severity of the crisis and the phenomenon of universal participation mean that the Social Security crisis also has the potential to turn the whole population against the government.

The politics of the crisis will have economic consequences as well. The political risks involved in raising taxes, cutting benefits, or both, give politicians a strong incentive to defer action as long as possible, meanwhile relying on deficit finance to cover Social Security's growing cash deficits. As these deficits grow they may eventually translate into debt monetization and an accelerating and ruinous inflation.

## IV.

### OPTIONS FOR REFORM

**P**ROPOSALS to reform Social Security range from minor tinkering that keeps Social Security's essential nature intact, to major changes such as investing Social Security funds in stocks or partial or total "privatization." Space permits examination of only a few representative plans, which will illustrate the main features, and problems, of most reform proposals.

#### PIA

In these discussions, PIA stands for Primary Insurance Amount, which is calculated by the Social Security Administration (on the basis of its records of earning and taxes) for every individual eligible to receive benefits. Briefly, one's PIA is the monthly amount one would receive when retiring at full retirement age before any adjustments for marital status, dependents, early retirement, earnings after reaching retirement age, cost of living, etc.

For an individual who first becomes eligible for old-age insurance benefits or disability insurance benefits in 2007, or who dies in 2007 before becoming eligible for benefits, the PIA will be the sum of:

- (a) 90 percent of the first \$680 of average indexed monthly earnings, plus
- (b) 32 percent of the average indexed monthly earnings over \$680 through \$4,100, plus
- (c) 15 percent of average indexed monthly earnings over \$4,100.

These amounts, \$680 and \$4,100, are known as "bend points."

AIME or Average indexed monthly earnings are based on the history of one's earnings subject to Social Security taxes, indexed by changes in the national average wage.

COLA is the annual cost of living adjustment.

See the Appendix for more information on these and other terms.

### *Maintain with Minor Tax, Benefit Adjustments*

Social Security's partisans maintain that there is nothing seriously wrong with Social Security, and that minor tax increases, benefit cuts, or both will suffice to keep it solvent.

This approach seeks to close the long-term actuarial deficit. The Board of Trustees' *Annual Reports* over the last ten years puts the actuarial deficit in the range of 1.86 percent to 2.23 percent of taxable payroll, and pointed out that an immediate, permanent payroll tax increase of about 1.95 percent points of payroll would eliminate the long-term actuarial deficit. Hence, enacting a mix of tax increases and benefit reductions sufficient to eliminate the actuarial deficit was sometimes called the "1.95 percent solution."

For example, the Trustees regularly analyze dozens of such small changes, and estimate their impact on the actuarial deficit. Table 1 presents a sampling. We see that in some cases the projected deficit reduction can be surprisingly large. Moreover, most of these adjustments considered separately do not inflict much discomfort, and hence may have a good chance of being accepted by the public.

However, some of these changes conflict with Social Security's goals. If the goal is to ensure adequate retirement income, then changes that affect all beneficiaries proportionately are less desirable than ones that slow the growth of benefits for higher-income retirees more. Even raising the retirement age raises the issue of equity. Increasing it from 68 to 70 would favor higher-wage workers because they tend to outlive lower-wage workers. And although life expectancy is projected to continue increasing, this will not necessarily translate into an increased period of good health in which people can keep working. At some age it will not. If the objective is to help the truly needy, it would be better to base eligibility on something besides age than to keep raising the retirement age.

Some proposals stand little chance of adoption because they would be too unpopular. The options yielding the greatest savings are, of course, the ones that would encounter the most opposition. Reducing the COLA by one percentage point percent would put a dent in the actuarial deficit, but could also be political suicide. Congress is much more likely to make smaller changes in hopes of postponing major reform.

Also, eliminating the long-term actuarial deficit will not necessarily eliminate cash deficits in the later or "out" years of the 75-year period. A long-term actuarial balance of zero does not mean that revenues equal costs

every year. It means that the initial assets in Social Security's trust fund, plus the income stream over the period, just suffices to cover the costs over the period, including any annual cash deficits in the out years, and leaves a target level of assets in the trust fund at the period's end. Those cash deficits would still have to be covered by general revenue or borrowing from the public. So even with the long-term actuarial deficit eliminated, Social Security would still have an impact on the budget in the out years, perhaps a substantial one.

More fundamentally, eliminating the actuarial deficit does little to make Social Security more affordable. The 2007 *Annual Report* puts the long-term actuarial deficit at -1.95 percent of taxable payroll. But the total summarized cost rate for the 75-year period 2007-2081 is 18.55 percent of payroll.<sup>17</sup> So eliminating the deficit through benefit reductions would produce a cost rate of 16.6 percent (18.55-1.95). Viewed differently, OASDI cost is estimated to rise from the current level of 4.3 percent of GDP to 6.3 percent in 2081.

### ***Maintain Benefits, Invest the Trust Fund***

The Office of the Chief Actuary for Social Security regularly analyzes provisions suggested to modify Social Security and improve its finances. Many provisions would essentially preserve the program's existing tax and benefit system. However, one provision prescribes that a portion of the Social Security trust funds be invested in marketable securities (*e.g.*, equities and corporate bonds), rather than 100 percent total investment in special-issue government bonds, as under current law.

The plan analyzed assumed a portion, rising eventually to 40 percent, of Social Security's trust fund would be invested in marketable securities. Presumably, the fund's overall investment portfolio, would be selected and monitored by an investment policy board. The hope is that the investment returns on equities will be high enough to maintain benefits promised under current law without raising taxes.

What would happen if the investments did not perform as well as expected? The Trust Fund would go into actuarial deficit. When this happened in the past, the government cut benefits or raised taxes. If the stock market boomed, however, it might be possible to increase benefits or cut taxes.

Both possibilities suggest a major concern about making Social Security's

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<sup>17</sup> 2007 *OASDI Trustees Report*.

Table 1: **Potential Savings in Long-Term Actuarial Deficit from Selected Options for Changing Social Security Benefits**

<i>Provision</i>	<i>Long-Range Actuarial Balance</i>
<b>Cost of Living Adjustment</b>	
• Beginning December 2006, reduce cost-of-living adjustment for OASDI benefits by one percentage point.	-0.44
• Beginning December 2006, reduce cost-of-living adjustment for OASDI benefits by 0.5 percentage point.	-1.16
• Beginning December 2006, use the “chained” CPI for COLAs, estimate to reduce the COLA by 0.22 percentage point.	-1.58
<b>Provisions Affecting Level of Monthly Benefits (PIA)</b>	
• Increase the number of years used to calculate benefits for retirees and survivors (but not for disabled workers) from 35 to 38, phased in 2006-2010.	-1.64
• Increase the number of years used to calculate benefits for retirees and survivors (but not for disabled workers) from 35 to 40, phased in 2006-2014.	-1.46
• Reduce benefits by three percent for those newly eligible for benefits in 2006 and later.	-1.56
• Reduce benefits by five percent for those newly eligible for benefits in 2006 and later.	-1.31
• For those newly eligible for OASDI benefits in 2012 and later, reduce PIA formula factors so that benefits grow by inflation rather than by increases in real wages.	0.45
• Progressive price indexing of PIA formula factors beginning with individuals newly eligible for OASDI benefits in 2012. Create new bend point at the 30th percentile of earners. Maintain current-law benefits for earners at the 30th percentile and below and reduce upper two formula factors (32 percent and 15 percent) such that maximum worker benefit grows by inflation rather than the growth of average wages.	-0.50
• For those newly eligible in 2013, multiply the 90 and 32 PIA factors each year by 0.9925 and 0.982, respectively. Stop reductions in 2050. Beginning with those newly eligible in 2008, multiply the 15 factor by 0.982. Stop reduction of the 15 factor in 2045. DI will have present-law scheduled benefit and proportional reduction at conversion to retired worker benefits at normal retirement age, based on years of disability.	0.15
<b>Provisions Affecting Retirement Age</b>	
• Eliminate hiatus in the normal retirement age (speed up increase to age 67).	-1.78
• Eliminate hiatus in the normal retirement age (speed up the increase to age 67) and then index the NRA (by one month every two years) until the NRA reaches age 68.	-1.40
• Eliminate hiatus in the normal retirement age (speed up increase to age 67) and then index the NRA by one month every two years until the NRA reaches age 70.	-1.24

<i>Provision</i>	<i>Long-Range Actuarial Balance</i>
<ul style="list-style-type: none"> <li>• Eliminate hiatus in the normal retirement age (speed up increase to age 67) and then increase the NRA two months per year until the NRA reaches age 68. -1.30</li> <li>• Shorten hiatus in the normal retirement age (speed up increase to age 67). That is, increase the NRA by two months per year for those attaining age 62 in 2012 through 2017, five years earlier than in current law, which would increase the NRA two months per year for those reaching age 62 in 2017 through 2022. -1.86</li> </ul>	
<b>Provisions Affecting Payroll Tax Rates</b>	
<ul style="list-style-type: none"> <li>• Raise payroll tax rates (for employees and employers combined) by two percentage points in 2006 and later. 0.04</li> <li>• Raise payroll tax rates (for employees and employers combined) by 2.1 percentage points in 2020 (to 14.5 percent combined) and by an additional 2.1 percentage points in 2050 (to 16.6 percent combined). 0.05</li> </ul>	
<b>Provisions Affecting OASDI Contribution and Benefit Base</b>	
<ul style="list-style-type: none"> <li>• Beginning in 2006, make all earnings subject to payroll tax (but retain the current-law taxable maximum for benefit calculations). 0.28</li> <li>• Beginning in 2006, make all earnings subject to payroll tax and credit them for benefit purposes. -0.10</li> <li>• Determine the level of contribution and benefit base such that 90 percent of the earnings would be subject to payroll tax (phased in 2006-2015). All earnings subject to payroll tax would be used in determining benefits. -1.09</li> <li>• Make 90 percent of the earnings subject to payroll tax (phased in 2008-2017), but retain the current-law taxable maximum for benefit purposes. This estimate considers all self-employed earnings in computing the percentage of earnings subject to payroll tax. -0.93</li> </ul>	
<b>Provisions Affecting Coverage of Employment</b>	
<ul style="list-style-type: none"> <li>• Cover newly hired state and local government employees beginning in 2006. -1.71</li> </ul>	
<b>Provisions Affecting Trust Fund Investment in Equities</b>	
<ul style="list-style-type: none"> <li>• Invest 40 percent of the Trust Fund in equities (phased in 2006-2020), assuming an ultimate 6.5 percent real rate of return on equities. -1.04</li> <li>• Invest 40 percent of the Trust Fund in equities (phased in 2006-2020), assuming an ultimate 5.5 percent real rate of return on equities. -1.29</li> <li>• Invest 40 percent of the Trust Fund in equities (phased in 2006-2020), assuming an ultimate three percent real rate of return on equities, the same as the assumed ultimate yield on the special-issue Social Security trust fund bonds. -1.02</li> </ul>	
<b>Provisions Affecting Taxation of Benefits</b>	
<ul style="list-style-type: none"> <li>• Tax Social Security benefits in a manner similar to private pension income beginning in 2006. Phase out the lower-income thresholds during 2006-2015. -1.60</li> </ul>	

1. Estimates based on the intermediate assumptions of the 2005 Trustees Report.

2. Long-Range Actuarial Balance under present law is -1.92.

Source: Office of the Chief Actuary, Social Security, 2006.

finances dependent upon the stock market: it gives the government a compelling interest in a perpetual bull market, and creates a strong incentive for politicians to exert pressure on fiscal and monetary policy to keep the economy and financial markets booming. Appointments to the Federal Reserve System's Board of Governors might be biased toward favoring monetary expansion, so as to promote bull markets. Not only would this impart an inflationary bias to monetary policy, but it could compromise the Fed's independence.

Moreover, putting trillions of retirement dollars under government management would partially nationalize American enterprise, *i.e.*, create partial socialism. There is also potential for political mischief with investments. A small group of appointed officials might wind up deciding how to invest trillions of tax dollars. Although their charter supposedly would be limited to the fiduciary role of selecting the best investments for workers and beneficiaries, it is not hard to imagine their decisions being influenced by other considerations.

Suppose the Trust Fund held stock in a company being sued for sex or race discrimination. How would the fund's supervisors respond to inevitable demands that it divest its shares? Would a government-owned and government-managed fund hold tobacco stocks, or stocks in companies that sell products made by cheap labor in China? Concentrating so much power in the hands of a few would invite political meddling in investment decisions. As Stephen G. Elkins of the National Association of Manufacturers observed, "As the debate over reforming Social Security proceeds, the question of government control over portfolios ought to be among the primary matters for consideration. And we can expect familiar voices to advocate 'investment in the public interest,' or some such. The prospect of *mega-scratch* available for ETIs [Economically Targeted Investments] under privatized Social Security will create a policy magnet with the kind of attractive force attributed to celestial black holes."<sup>18</sup>

Also, this plan would require higher general taxes or government borrowing. If surplus payroll taxes were invested in stocks, the Treasury would lose a revenue source. In addition, if part of the Fund were redeemed to invest the proceeds in stocks, the Treasury would have to raise money to

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<sup>18</sup> Stephen G. Elkins, "Correspondence: Targeting Social Security," *The American Spectator*, April 1996, p. 75.

repay principal and interest. Either taxes would have to rise, or the deficit would increase, or other Federal spending would have to be cut.

### *Small Publicly Held Individual Accounts*

Another idea some back is a benefit financed by compulsory savings accounts, funded by, say, a 1.6 percentage point increase in the payroll tax paid by employees. The government would collect and manage the revenue, but each worker would have an account held in his name. He would decide how to invest it, but his choice would be limited to stock and bond index funds selected by the government.

Any time after turning 62, the individual could elect to convert the accumulated value of his account into a stream of annuity income. If he died before retiring, the fund would pass to his estate, but if he died after annuitizing, his survivors would receive only a small payment, perhaps one year's annuity income. Married retirees would have the option of choosing a smaller annuity that would continue to be paid to the surviving spouse.

Annuitizing would be the only option for withdrawing funds. This restriction presumably is intended not only to assure a steady income until death, but to eliminate the possibility that shortsighted retirees would draw down their savings too fast. There would be considerable pressure for the government to bail out such people with additional benefits.

A proposal like this has some attractions. It does take some steps to address the crucial problem of Social Security's exploding costs. And unlike the existing program, it contains a saving component for the individual. Moreover, it skirts the transition costs problem of more ambitious privatization proposals, which we take up next.

However, the smallness of the principal injections (1.6 percent of taxable income) means that accumulations would be modest for all but the highest incomes. A worker with a taxable income of \$20,000 would have an annual principal increment of \$320 ( $\$20,000 \times .016$ ), meaning it would take him 50 years to save a principal of \$16,000, which is pitifully inadequate given what the cost of living will likely be 50 years from now.

In contrast to other proposals, this one puts much of the responsibility for investing on the individual rather than the government. An individual would receive a higher annuity income if his investments did well, but would get a smaller one if they did poorly. An important question is whether the government would bail out individuals whose investments did badly. There

would be considerable political pressure to do so, especially because these would be government-mandated accounts financed with taxes and invested in index funds chosen by the government.

Political forces might also influence the annuity income rates offered to retirees, if they were set by the government rather than private insurers. Among other things, there would be pressure to provide inflation-indexed annuities, which few private insurers offer. On the other hand, if the annuities were sold by private insurers, there would be pressure to bail out annuitants if the companies failed. In addition, this plan raises some of the same concerns about the government's role in the financial markets as a provision discussed earlier. These include the economic and political implications of having the government choose the investments available to workers, and tying a huge mandatory savings and entitlement program to the fortunes of the stock market.

### ***Privately Held Personal Accounts***

This category of proposals is the most radical. Many variations have been forwarded; only one is briefly discussed: President Bush's plan.

President Bush claims his reform leads to "a better deal for younger workers by allowing them to put part of their payroll taxes in personal retirement accounts." The best part, according to Bush, is that it "replaces the empty promises of the current system with real assets of ownership."

First, personal retirement accounts (PRAs) would be voluntary. At any time, a worker could create a PRA by making a one-time election to set aside a portion of his payroll taxes. Workers who do not elect to create a personal retirement account would draw benefits from the traditional, but "reformed to be sustainable," Social Security system.

Under Bush's plan, yearly contribution limits would be raised over time, eventually allowing workers to divert four percentage points of their payroll taxes into a PRA. The accounts would operate similar to the Federal employee retirement program, known as the Thrift Savings Plan (TSP). A centralized administrative structure would be created to collect PRA contributions, manage investments, maintain records and facilitate withdrawals at retirement. Workers would be limited to allocating their PRAs among a small number of broadly diversified index funds, including a government bond fund with a guaranteed rate of return above inflation. Fees would be regulated.

Those with personal retirement accounts could not make withdrawals or take loans from, or borrow against, their accounts before retiring, nor could the account be emptied out all at once. A poverty-protection threshold also would apply. Any balances in excess of that used to establish an annuity sufficient to ensure a stream of monthly income over the worker's life expectancy, however, could be withdrawn in a lump sum. Finally, any unused portion remaining upon death could be passed on to survivors.

The main advantage of this plan is that it gives individuals the most control over their investments. Although the accounts would be subject to regulation, much as IRAs now are, there would be less potential for political interference with investments than with the other two plans. In addition, by shrinking the guaranteed benefits to a floor of support, it does more—over the very long term, once it is fully phased in—to alleviate Social Security's financial problems.

Based on analysis by the Social Security Actuary, the plan will require transition financing of \$754 billion (including interest) over the next 10 years. But financing the transition will have to compete with exploding claims on the Treasury because Medicare and Medicaid outlays also will soar as the population ages. In that context raising the money may prove difficult, which may lead to debt monetization and inflation. Moreover, the taxing and borrowing needed to finance the transition may seriously impair the economy's performance, which in turn will depress equity returns below what two-tier plans assume. Here again, the government would have a compelling interest in bull markets in equities, raising the problem mentioned earlier of biasing economic policy, especially monetary policy.

Although this plan comes closest to "privatizing" Social Security, it does not entirely return responsibility for planning their financial futures to the younger people most affected by it. It forces them to save for their retirement, rather than letting them spend or invest their earnings as they choose. Many young workers would probably rather save for a down payment on a house, pay back student loans and other debts, buy a car, take a vacation, etc.

Full "privatization" would let individuals decide not only how to invest their retirement savings, but how much (if anything) to save for retirement. The risk, of course, is that people would not save enough and the government would end up paying for their retirement anyway—but if their expected benefit was small, it is likely that most people would try to save

more. People could be encouraged to save, rather than forced, by adopting tax policies that make saving more attractive than spending. One possibility would be replacing the income tax with a consumption tax.

### *Critical Assumptions about the Stock Market*

All of these plans project that benefits under the reformed program would on average be at least as big as those Social Security pays now. However, this happy outcome rests on some dubious assumptions, particularly regarding investment returns. All proposals assume that the average real rate of return on stocks will be 6.5 percent; corporate bonds, 3.5 percent; and long-term government bonds, three percent.

These projections amount to little more than fantasy. There is little basis for expecting securities to provide the same return in the future as they did in the long-term past. In particular, massive flows of Social Security revenues into and out of the markets could have a significant, if unpredictable, impact on the financial markets, the economy and savings behavior.

In addition, there have been prolonged periods when the return on stocks and bonds was higher or lower than the long-term historical average. Moreover, the assumption that stocks will consistently outperform bonds, thus providing the extra returns needed to finance projected benefits, is doubtful in light of historical experience. There have been long periods in which this has not happened. For roughly 25 years, 1961-1985, the return on stocks and five-year Treasury bonds was roughly the same. For the 20-year period 1961-1980, the return on stocks and 90-day Treasury bills was about the same.

In 1996 John Dizard, *National Review's* "Gekko," argued that the idea that investing Social Security's trillions in stocks with the expectation that fabulous returns would bail out the program is nonsense. "The rest of the country seems to take sustained high returns for granted, but my Wall Street friends talk about Social Security privatization as the ultimate sign of a top. ... [F]or the huge U.S. equity market, a 13 percent annualized return [like that achieved by the Chilean equity markets since its social security system was privatized] is a fantasy—we'd own the nearby planets as well as the world by the time the Generation Xers retired. There is of course a way around this mathematical impossibility—a dramatic 'correction' in the public equity markets."<sup>19</sup>

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<sup>19</sup> John Dizard, "Gekko," *National Review*, March 25, 1996, p. 32.

The uncertainty and volatility of investment returns has significant implications for the foregoing plans. Under the public accounts plan, the government would directly bear the investment risk—it would be relying on investment returns to help finance the current program and would have to turn to other revenue sources to make up any shortfall. Under privatization plans, the value of a person’s account would vary during his retirement, unless he bought an annuity. How would the government deal with people whose investments did badly, or who made poor investment choices?

### ***Will Privatization Really Increase Savings?***

A widespread but misguided notion is that “funding” Social Security with private financial assets will increase the nation’s savings rate, boosting economic growth and enabling us to afford keeping the elderly in the style to which they have become accustomed. In reality, the Treasury will be taking the same amount from the capital markets as Social Security is bringing.

Even the plan which calls for putting some percentage of earnings in individual accounts over and above the existing payroll tax (in the expectation that the returns on those investments will compensate for benefit reductions) would only increase the savings rate to the extent that workers maintained their current savings rates after the amount put into the individual account was taken out of their paychecks.

More to the point, we have long argued that the savings rate is only part of the problem of capital formation: the nature of the capital formed may be even more important. Mandatory diversion of hundreds of billions into the securities of well-established firms would surely reduce the funds available to the most dynamic enterprises—the small businesses and new ventures that have been the largest source of output and employment growth.

### ***Other Difficulties with Privatization***

Proposals to put some Social Security funds in the stock market reflect the hope (and it is only a hope) that the returns on those private financial assets will eventually serve to curtail the “pay-as-you-go” tax burden of supporting retirees. Yet, even if some of future retirees’ benefits are funded with private assets, the Treasury will still have to find the huge sums needed to pay currently promised benefits while it waits for the payoffs. That need will only be exacerbated by using funds to “play the market” rather than to pay benefits.

Also, it is hard for us to understand how Social Security could be privatized in any conventional sense. The primary reason is simple: what private concern (insurance and annuity company, investment house, pension fund, etc.) would be willing to assume a multi-trillion dollar unfunded liability extending many decades into the future?

Or consider the oft-cited Chilean model. In 1981 Chile replaced its pay-as-you-go old-age social insurance program with mandatory individual retirement accounts into which individuals were required to put a portion of their earnings, invested in private pension funds selected by the workers. Workers entering the new system were given “recognition bonds,” which they could redeem at retirement, for the value of their payroll tax payments into the new system.

This model seems attractive, but there are decisive differences between Chile’s situation and ours. The Chileans financed the transition partly by selling their many state-owned enterprises and undeveloped natural resources. The U.S. government, however, has no such state enterprises to sell. Much of its land is desert. In America, unlike Chile, virtually all useful physical assets are already in private hands. Almost by definition, anyone here who acquires a government-funded enterprise or government-owned property is buying a loser. Furthermore, Chile’s population is much younger than America’s, making their social security problem much less difficult to begin with than ours is. And the Chilean government, unlike ours, was running substantial budget surpluses, which made the transition easier.

### *Supporting the Elderly*

The notion of retiring from productive life before one’s productive abilities have been exhausted is a relatively recent one. Nevertheless, while some primitive societies abandoned their unproductive members in jungles or on ice floes, civilized societies provide for their elderly and infirm. Traditionally, this support came from the individuals’ families. In more advanced civilizations, especially those with financial systems that facilitated long-term saving, individuals became able to provide for their old age. Finally, most industrial economies have some system, such as Social Security, of forcibly transferring income from workers to the elderly.

Despite the longing of those who deplore government handouts, the program’s goal—ensuring the elderly some means of support—remains. Low birth rates and high divorce rates mean that large and extended fami-

lies have become rare. Some people are improvident or unlucky. Having precluded much retirement saving by individuals, Social Security's high tax will cause continued high dependence on Social Security in the future. Given all this, we can expect that the government will continue transferring income from workers to the elderly.

Social Security is, to repeat, an income transfer program. Unless this is more widely recognized, efforts at reform are unlikely to address the real issues: what level of support do we want to guarantee to the elderly via transfers, what is to be the age and/or circumstance of those qualified for such support, how can we make such a system affordable, and what is the best way of financing it? Should the government continue to operate a "pension plan" designed to provide substantial incomes (*i.e.*, above a basic subsistence)? The current system is clearly untenable. Without major changes, it will eventually make most workers poorer than the retirees they have to support.

### ***AIER's Proposal: Equalize Benefits, Repudiate Myths***

We believe that the solution is to make benefit payments even more progressive than they are now. If the goal is to provide a basic subsistence to the elderly, Social Security's minimum payments may be too low and maximum benefits clearly excessive. We believe that a successful reform should ultimately make benefits equal for everyone. This means scrapping the notion that the program resembles savings or insurance. This applies to both the benefits and the revenue that pays for them.

Equalizing benefits for all Social Security beneficiaries at a level that the productive members of society can afford cannot, in fairness, be accomplished quickly. Current retirees and those nearing retirement years have planned on specific levels of benefits that should not be markedly changed overnight.

Current recipients' benefits are based on their PIAs, and it is possible to calculate PIAs for younger workers (in the same way that the benefits of disabled workers, which are based on their PIAs at the time of disability, are calculated). One way to gradually equalize all PIAs would be to calculate all these amounts under current law as of a cutoff date. Thereafter, instead of computing increases in individuals' PIAs using the average wage index, all PIAs could receive the same *dollar* increase.

One way to compute the annual dollar increase in PIAs would be to

base it on the COLA for the maximum benefit payable to an individual under Supplementary Security Income (SSI), the general-revenue-financed program for elderly and disabled Americans with no other income source. In 2006 this benefit, for an individual living in his own household with no other countable income, was \$603 monthly, and for a couple, \$904. (Since 1975, SSI benefits have been increased by the same percentage as the Social Security COLA.)

To reflect any general increase in living standards, the increase might be based on changes in the average wage. Under this regime, if the average wage rose 3.5 percent (reflecting, say, a 2.5 percent increase in the cost of living and a one percent increase in productivity), the increase in the maximum SSI benefit would be about \$21 per month, raising the individual benefit from \$603 to \$624. This same dollar increase could be given to everyone receiving Social Security benefits.

The objective is to gradually decrease the purchasing power of the benefits of those with high PIAs, who have been and will continue to be those best able to provide for themselves, and increase the purchasing power of the minimum payments that mainly go to the truly destitute. At some point, very few individuals would remain with PIAs above the minimum. Eventually, everyone would get the same amount.

### ***Abolish the Payroll Tax***

Our proposal should limit OASDI's future outlays. It would also eliminate vast amounts of bookkeeping for employers and for the government itself because, after the cutoff date, keeping track of earnings histories and Social Security tax payments would be unnecessary.

More significantly, if Social Security was seen as just another federal program, there would be no need to maintain the fiction that it is insurance "paid for" by worker "contributions," and the link to payroll taxes could be broken for good. If this were accomplished, the payroll tax could be examined on its own merits or, as we believe, lack thereof. We believe that the appropriate course is to abolish the payroll tax. This would, of course, leave a gigantic void in federal receipts. Something would be needed to replace it. Our candidate is a value-added tax.

### ***A Value Added Tax***

The value added by an enterprise is the difference between its revenues

or sales and the cost of the goods and services purchased from other firms. A value-added tax (VAT) is essentially a sales or turnover tax, with the important difference that a specific enterprise gets, in effect, a credit for the taxes paid by its suppliers. This means that the tax base of a VAT includes the same base as payroll taxes (compensation of employees) *and* whatever is left over after suppliers and vendors have been paid, which is the return to capital (interest and profits).

A long-standing objection to a VAT is that it is regressive. However, a VAT is a proportional (neither regressive nor progressive) tax on consumption: it is regressive only to the extent that lower-income people consume a higher proportion of their incomes. Savings are not taxed. If a family with an income of \$20,000 somehow saved \$1,000 in a year, the value added tax on their consumption of \$19,000 would be a lower proportion of their income than it would for a family with an income of \$200,000 that spent it all. The current payroll tax claims a higher proportion of the income of the \$20,000 per year family than it does from the \$200,000 family, no matter what either family does with the money.

Because it is simple, and because enterprises have a strong incentive to declare their purchases from vendors, a VAT is comparatively easy to administer. Compliance and so-called “horizontal equity” (the principle that those in equal circumstances pay equal taxes) generally are better than for income taxes—there are far fewer gray areas subject to interpretation and dispute.

With the broadest base of any tax, the VAT is a very robust revenue raiser. Thus it is with some trepidation that we suggest it. We stress that we only advocate a VAT as a replacement for the payroll tax and, because it taxes income from capital as well as labor, as a replacement for the corporate income tax as well.

### ***Abolish the Corporate Income Tax***

Congress imposed the corporate income tax four years before passage of the 16th Amendment to the Constitution permitting taxation of individual income. This reflects an early understanding that corporations do not pay taxes, they simply collect them on the government’s behalf. The notion may have been that, with ownership of corporate equities concentrated among the wealthy, a corporate profits tax would fall disproportionately on the rich, and the tax may have been enacted as an “end run” around the constitutional

prohibition on an income tax. (Article I, Section 9 prohibits “a capitation or other direct tax, unless in proportion to the census.”)

The corporate income tax was retained even after the 16th Amendment was ratified. Its significance for federal revenues varied greatly over the years. For some years during World War II it raised nearly half of federal receipts, but after the war its share of revenue fell, and is now less than 10 percent of receipts.

The top *marginal* rate of Federal corporate profits taxation has varied from one percent (from 1909-1916) to 52.8 percent from 1968-1969. Many industries faced much higher rates on “excess profits” during World War II and the Korean War, as did many oil producers under the 1980-1991 “windfall profits tax.” The current rate is 35 percent, but the decline in significance of corporate profits taxes has not been simply a function of lower rates. The *effective* rate has usually been much lower than the marginal rate, because of various exemptions, credits and methods of calculating profits (accelerated depreciation, in particular) designed to encourage corporations to behave in certain ways.

### *Who Pays?*

Corporations are a way that people organize themselves—corporations do not pay taxes but collect them on behalf of the government. Although the corporate income tax may have been imposed in an attempt to tax the rich, the notion that profits taxes are paid by “rich” stockholders is questionable.

The evidence strongly suggests that profits taxes simply are shifted to and collected from customers in the aggregate and over the long term. The tax becomes another cost of doing business that is imbedded in the selling price.<sup>20</sup> The profits tax would thus appear to function as a sales or value-added tax. This is a major reason why profits taxes should be abolished if a VAT were levied.

However, unlike a straightforward VAT, the profits tax is capricious. It will affect the shareholders of a given firm when that firm’s profits fluctuate in the short term. For example, if the hula-hoop fad revives, a hula-hoop manufacturer’s profits and taxes will soar. If profits subsequently become losses, say, because the new plant comes on line just as the fad ends, the

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<sup>20</sup> See, e.g., a much quoted article by Arnold C. Harberger, “The Incidence of the Corporation Income Tax,” *Journal of Political Economy*, vol. 70, no. 3 (June 1962), pp. 215-240.

firm may be able to claim a refund for taxes paid in prior years. Perhaps more significantly, a given corporation's taxes can vary enormously to the extent that it can use various loopholes ("tax incentives") that Congress has written into the law.

### *Political Mischief*

Thus the real mischief of a profits tax is that it enables politicians to grant favors. One reason why its effective rate has usually been far below the marginal rate has been that Congress often has permitted larger write-offs (for depreciation of plant and equipment, and for depletion of mineral resources) than are indicated by financial or economic accounting, thereby reducing taxable income and profits taxes. Moreover, Congress has allowed various tax credits and exclusions that further have reduced the tax. These have not been uniform over time or even across industries; some have been written so narrowly that they benefit only one company! Such "tax incentives" reflect a history of lobbying to obtain legislation favoring special interests. When campaign contributions are solicited, these interests no doubt remember which politicians were "helpful."

Because the tax base would be enlarged, the VAT rate needed to replace the revenues now generated by the payroll tax and the corporate profits tax should be lower than the 12.4 percent OASDI tax and much lower than the 35 percent marginal profits tax rate. A lower tax rate on capital and labor would reduce the employment disincentives of the current tax system. And because a VAT would not distinguish between the returns to equity and debt capital, it would remove the current system's bias in favor of debt financing.

Various transition rules no doubt would be needed to ensure the continuity of employees' take-home pay and employers' costs before and after the cutoff date. Other provisions would be needed to ensure that the value added of financial corporations, sole proprietorships, partnerships, nonprofit organizations and governments (where the notions of revenues or sales and the nature of personal compensation can differ from nonfinancial corporations) would remain in the tax base.

### *Outlook*

Readers may be aware that a tax on the site value of land is the only tax that we believe serves to facilitate rather than hinder the economic process.

We make the above recommendation only because the best should not be the enemy of the good; a VAT would be better than what we now have, even if better alternatives can be imagined. Readers who object to our recommendations should rest assured that we rate as close to nil the chance that Congress would adopt them. Politicians of both parties have painted themselves into a corner on the question of curtailing benefits and have a huge vested interest in maintaining the myth that beneficiaries have paid for Social Security. Given its decreasing contribution to Federal revenue, the corporate profits tax may exist mainly to keep the money flowing to “the best Congress money can buy.”

## V.

### OPTIONS FOR YOU

**W**HAT does all this mean for you? To answer, let us first examine what is likely to happen with Social Security, then take up what this implies for you and, finally, what you should do.

#### *Social Security's Likely Outlook*

Although projections of future outlays by Social Security's actuaries are best taken as rough indicators of their likely order of magnitude, it is clear that under current law, Social Security will soon become unaffordable. In its present form it is unsustainable.

Denial of this unpleasant reality has become widespread in America. It is crucial that you not make this mistake about Social Security. Do not assume that "they" will "do something" to save the program and protect your benefits. Assume that they will do something to *cut* your benefits.

Do not assume that faster economic growth will bail Social Security out. Faster growth could help keep the current system intact, but we might enter a period of low growth and accelerating inflation such as the 1970s. Do not assume that immigration will save Social Security. Unless more than matched by greater capital formation, higher immigration levels could depress labor productivity and real wage growth, with negative implications for Social Security's revenues. In any event, immigrant workers eventually become beneficiaries. Assuming these developments is leaning on luck. The stakes—your well-being in old age—are too high for that.

A gap between the rhetoric and the reality of Social Security already exists, and it is likely that more discrepancies will emerge. Politicians of both parties will pledge not to cut benefits for current retirees and baby boomers, but reality will force them to find some way to reduce costs. Because explicitly reducing benefits would be political suicide, benefit cuts will be done covertly and deviously. Possible methods include higher and more progressive benefit taxation or further increases in the retirement age. Since projected further increases in longevity and declines in death rates will make it prohibitively costly to permit tens of millions of baby boomers to take early retirement, Congress will probably try to discourage early retirement by further cutting the early retirement benefit as a share of the PIA—to, say,

60 percent or even 50 percent; raising the age at which one can first qualify for early retirement from 62 to, say, 65 or 67; or both. Another likely indirect benefit cut will be revised computation of the Consumer Price Index, officially to make it “more accurate,” but actually to reduce COLAs.

Social Security taxes will probably be raised, but insidiously, so as not to provoke the young. The demagogic appeal of class war being perennial, we might see the contribution and benefit base (maximum income subject to tax) increased for tax purposes, but *not* for computing benefits, as an underhanded stiff-the-rich measure. Introduction of progressivity in the payroll tax is another revenue enhancement with class-war potential. Congress may resort to partial general revenue financing. It has been proposed before. (In 1980 independent presidential candidate John Anderson proposed taxing gasoline 50 cents a gallon for this purpose.)

Politics being what they are, we can expect such pain-inflicting measures to be postponed as long as possible and, once imposed, to be inadequate. So for at least the first several years after about 2018, Social Security’s cash deficits will likely be closed by asset redemption, which will almost certainly mean larger budget deficits.

Partial or total privatization is unlikely for a variety of reasons. For one, the stock market would have to turn strongly and persistently bullish. Second, the Democratic Party strongly opposes privatization. Finally, since most baby boomers have done little to save for their old age, they will be heavily dependent upon Social Security, and their support for it will solidify as they near retirement. Once they have started receiving benefits, they are likely to oppose any attempt to privatize unless an explicit guarantee of their benefits is included—and they will have the numbers, and political clout, to get their way. (Having loudly made the guarantee, Congress will of course break it with underhanded cuts, pleading necessity.)

### *Implications for You*

It is of the first importance that you grasp the connection between Social Security’s prospects and your own—that you “connect the dots.”

If you are already retired and drawing Social Security, you are in the demographic cohort least likely to be seriously injured by the crisis. The politics of Social Security make explicit reduction in benefits to current beneficiaries the measure least likely to be adopted. However, insidious benefit cuts through higher benefit taxation, revising the Consumer Price

Index, etc., are likely and will at least somewhat reduce your retirement income. Because our political reward system encourages deferral of such measures, the older you are, the lower your chances of injury.

If you were born after 1945, however, it is likely that both the tax and the benefit provisions of Social Security will be changed to your disadvantage. The longer action is deferred, the more serious your eventual injury will be. Moreover, the young have less political power than the old in this matter.

### **Keep Track of Your Earnings**

The amount of your Social Security benefit and any benefits received by your dependents or survivors depends on your lifetime earnings. More accurately, it depends on the Social Security Administration's *record* of your lifetime earnings. These records, which are based on earnings reported by your employers, are not always accurate. Not uncommonly, there are mistakes in reporting and recording a worker's name, date of birth, or earnings. Indeed, a study conducted some years ago found that the official earnings records for millions of workers were inaccurate.

Although we believe that your prospective Social Security benefits will be inadequate for your retirement needs, you should make sure that the Social Security Administration's record of your earnings is accurate so that you will receive any and all benefits to which you may be entitled. Thus, you should periodically check your official earnings record for accuracy. To do this, you need a copy of your *Social Security Statement*. This is a concise record of the earnings on which you have paid Social Security taxes during your working years and a summary of the estimated benefits you could receive based on those earnings.

This statement is automatically mailed by the Social Security Administration each year, about three months before your birthday, to all workers and former workers aged 25 and older. You can also get a copy of it at any time by calling Social Security toll-free at 1-800-772-1213 and asking for the *Social Security Statement*. Request form (Form SSA-7004). You can also submit a request for the statement over the Social Security website, [www.ssa.gov](http://www.ssa.gov), or you can download the request form from this website and mail it in. You will receive your statement of earnings and estimated benefits through regular mail in two to four weeks.

It stands to reason that the younger you are, the worse your financial injury from Social Security's revision is likely to be.

The coming crunch in Social Security means that retirement will be increasingly difficult for most Americans. Most of us will have to work longer and retire later, if we are able to retire at all. The likelihood is that Social Security's shortfalls will be financed by borrowing. At some point, the option of inflating the national debt away may become irresistible. This obviously carries grim implications for the purchasing power of your savings and investments, and therefore for your ability to retire.

The all but inevitable benefit reduction makes it very likely that workers will need to save and invest much more than they do now to provide for old age. At the same time, higher taxes, and the possibility of inflationary stagnation caused by massive borrowing to cover the coming deficits, will make it harder to do. The painful but necessary implication is the need to curtail your current personal consumption so as to offset the inroads which these higher burdens will make on your investment funds.

In short, the coming Social Security crisis implies that to be in a position to enjoy a comfortable retirement you will have to work harder, save more and live more austere than you do now.

### *If You're Young, Assume the Worst*

If you are now working, do not plan your retirement around Social Security. Realize that benefits are malleable and will be cut. Assume that you will be stiffed in some fashion, and that Social Security will replace a smaller, perhaps much smaller, share of your labor income than it does for current beneficiaries under current law. Rely as much as possible on your own saving and investing. Realize that you may have to delay retirement for several years, or even forgo it altogether. In short, "Hope for the best—but prepare for the worst."

Realize too that the choices you make now—and not merely those regarding income, savings, and investment—will have decisive consequences for your old age. Unhealthy or irrational lifestyle choices will damage your prospects for living decently in retirement or even for retiring at all.

### *Employment: Now and in "Retirement"*

It is vital that you be flexible about your employment and be willing to learn new skills. Not only is job insecurity rampant thanks to globalization

and corporate efforts to minimize costs by shedding jobs, but it may be necessary for you to work more than one job. Obviously, the more skilled you are, the more employable you are, and the better able you are to command higher compensation for your labor. This will put you in a better position to save and invest for old age.

It is quite likely that you will be unable to afford to retire, or will have to work part-time in your old age, unless you had or have a secure, well-paying job with generous retirement benefits, or have been fortunate in your investments, or both. Unfortunately most Americans are not in this happy situation, so it will be helpful if you remain willing to learn and try new things as you age.

### *Saving for Retirement*

The virtual certainty that your benefits will be cut if you were born after 1945 makes it imperative that you save and invest as much as possible. But how much? The answer to that question is taken up in the next chapter.



## VI.

### ESTIMATING YOUR RETIREMENT SAVINGS GOAL

**E**VEN though there are many years to plan for it, saving for retirement frequently catches people off guard, as more immediate demands on income may crowd out a plan for saving. At the same time, for a variety of reasons saving for retirement has become more urgent than ever in recent years.

But just how much saving is required, given your circumstances?

Unfortunately, there is no foolproof way to answer this question. The future purchasing power of the dollar is highly uncertain, and with it the purchasing power of any pension payments you may receive. Nor is it easy to predict the rate of return on your savings. Meantime, the prospect of a traditional, fixed-benefit pension is fast fading into the sunset, so that more and more of the responsibility for saving is being shifted to the employee.

Nevertheless, even a rough estimate of retirement savings requirements seems preferable to remaining completely in the dark. Accordingly, we now describe how a savings plan, begun at a given age, can be designed to fund a specific retirement income.

It must be emphasized at the outset that the illustrations we will provide in this chapter are only a first approximation offering general guidelines as to how much you will want to save each month. In essence the answer is, the more saving the better. If you save too much, the worst thing that will happen is that you will leave a larger estate.

First, we review a number of factors to consider in estimating how large your post-retirement income should be to maintain your standard of living.

#### *Estimating Your Retirement Expenses*

Your expenses after retirement may differ substantially from those in your working years. The net effect for most people is that a smaller income—perhaps much smaller—can maintain your standard of living after retirement.

There are several reasons to expect expenses to go down. First, a large

part of the family budget before retirement is devoted to raising children, who, if all goes well, will be financially independent by the time you retire. Second, work-related expenses, such as commuting, clothing, etc., also will be lower. Third, mortgages may be paid off by this time. Fourth, once you reach retirement age you may be in a position to stop “saving for retirement.”

Finally, your tax bill may also diminish upon retirement. For many retirees, taxable income drops substantially. Depending on total income levels, Social Security benefits may be either tax-free or only proportionally taxed. Annuity income that represents return of principal is not taxed. Except for tax-sheltered retirement plans—such as 401(k)s—savings withdrawn to meet current expenses are not deemed “income” for tax purposes.

Moreover, federal tax law provides a higher standard deduction for taxpayers aged 65 or older who do not itemize. In 2005, the “additional standard deduction” was \$1,250 for single taxpayers. For those who were married filing jointly, married filing separately, or a qualifying widow or widower, the additional amount was \$1,000. State tax codes often provide similar deductions for the aged.

In addition, in many states “homestead exemptions” for property taxes allow seniors to pay lower property taxes on their homes. Nor are such exemptions trivial. In one western state, for example, a home with an assessed value of \$300,000 qualifying for the homestead exemption incurs a tax liability of \$520, rather than \$3,500. At the federal level, a homeowner is entitled to exclude from taxation up to \$250,000 (\$500,000 for married couples filing jointly) of the capital gain on the sale of a principal home.

Since your tax status may change considerably upon retirement, it may be worthwhile to consult a tax planner to ensure you are taking full advantage of the privileges of age accorded you by the IRS and by state and local governments.

By contrast, *medical expenditures* can be expected to increase. These increases may partially offset the reductions in expenditures noted above. True, Medicare becomes available at 65, but it is only a partial shield against rising health costs. This issue is too complicated to try to summarize here. According to the Bureau of Labor Statistics’ *2005 Consumer Expenditure Survey*, the out-of-pocket estimate of medical expenses after 65 was about \$4,200 a year. Suffice it to say, this outlay is likely to continue rising.

Similarly, at-home care costs may also rise in later years. Such costs may

include not only at-home health care, but a variety of home-maintenance and other services as well.

At bottom, health care and home care expenses in retirement are unpredictable. There is always the possibility that they will be very large. While it is hard to budget for unpredictable situations (few of us know what our health or personal circumstances will be 10 or 20 years from now), it is important to keep in mind that health-driven changes can become—gradually or suddenly—a major factor in your finances after you retire.

### ***Figuring Out Your Replacement Income***

The net effect for most people is that costs of living go down after retirement, at least initially, so a “replacement rate” of less than 100 percent of your preretirement income may be adequate. (A replacement rate is your gross income after retirement, expressed as a percentage of your income before retirement.) In other words, it typically takes a lower income after retirement to maintain the same standard of living, for the reasons just described.

How much lower depends on many factors, most notably your preretirement income. The Aon Consulting Group and a team of Georgia State University researchers have studied the question of how much recommended replacement rates vary with income. Using data from the Federal government’s Consumer Expenditure Survey, they periodically estimate the replacement rates that retirees, both individuals and couples, need at different income levels in order to maintain their preretirement standard

**Table 1: How Much Of Your Working Income Will You Need After Retirement?**

<i>Preretirement Income (2004 Dollars)</i>	<i>Replacement Rates to Maintain Standard of Living</i>	
	<i>Single</i>	<i>Married</i>
\$20,000	82%	89%
30,000	79	84
40,000	76	80
50,000	74	77
60,000	74	75
70,000	78	76
80,000	81	77
90,000	82	78

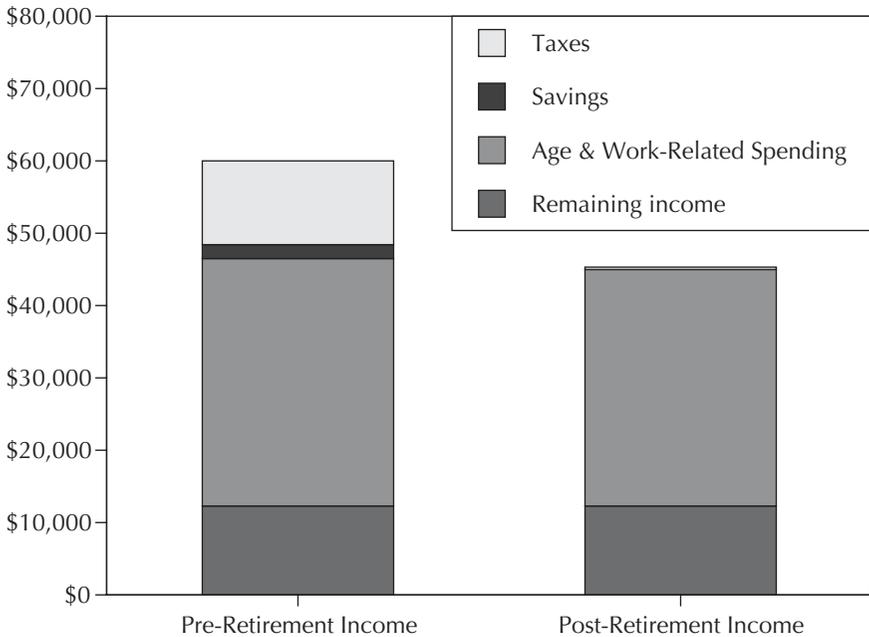
Source: The Aon Consulting/Georgia State University 2004 Retirement Income Replacement Ratio Study.

of living.

Their latest (2004) estimates were based on spending profiles of about 15,000 households, some still working and some after retirement. As indicated in Table 1, at first the necessary replacement rate goes down as income rises. For married couples, it falls to 75 percent at \$60,000. In other words, a couple with a gross income of \$60,000 before retirement would typically need an income of \$45,000 after retirement to maintain their standard of living. Above that income, however, the needed replacement rate begins to rise, approaching 80 percent at \$90,000.

Chart 1 shows why 75 percent is the recommended replacement ratio for a preretirement income of \$60,000. First, Federal taxes usually fall sharply once you stop working. Second, age-related cost reductions for large non-medical budget items (such as mortgages) often outweigh rising medical and other age-related expenses. Third, you no longer need to allocate part

Chart 1: **How \$45,000 in Retirement Income Can Replace \$60,000 of Preretirement Income**



Source: Based on data in The Aon Consulting/Georgia State University 2004 Retirement Income Replacement Ratio Study, p. 2.

of your income to “saving for retirement.”

However, above a retirement income of \$45,000, federal income taxes kick in again. As a result, it takes more pre-tax income in retirement to match the preretirement standard of living. Above a retirement income of about \$45,000, rising income taxes boosts the needed replacement rate from 75 percent to higher ratios.

This study suggests that, to be on the safe side, replacement rates ranging from 75 percent to 90 percent should be adequate for most people to maintain preretirement standards of living.

On the other hand, you are not a statistic. You do have your own personal circumstances and preferences to consider. For one thing, relatively higher annual earnings during the few years immediately preceding retirement may overstate the level of income needed to maintain current living standards. To that extent, an average of your annual earnings during the 10 years or so before retirement may be more representative of your preretirement income.

More subjectively, if you are in good health and have a willingness to experiment, you can find new lifestyles (or, better said, “consumption styles”) that can allow you to get by on less income than any of these comparisons suggest. The notion of a rigid or inflexible replacement rate assumes that you want your retirement lifestyle to resemble that of your working years. You may well imagine other possibilities. If so, you may manage to get by on a much lower income (say, 40 percent of your working-age income, not 75 percent) to provide you with an equivalent sense of well-being and security.

### *Sources of Income*

The point so far is that once you calculate your preretirement income, you can use a replacement rate to estimate the income you will need in retirement. If the average of your 10 years of income from age 55 to 65 is \$60,000, a replacement rate of 75 percent is in order, implying a target income in retirement of \$45,000.

Once you have estimated how much income you will need in retirement, you then must figure out where it will come from. Social Security benefits alone are unlikely to be enough for many people, particularly those with high earnings. The Social Security Administration estimates that benefits currently replace less than one-fourth of the earnings of a worker who earned the maximum subject to Social Security tax throughout his life-

time (for 2007, the maximum is \$97,500). However, few workers earned this maximum wage every year. For the majority, Social Security benefits typically will replace a larger portion of earnings. Indeed, the lower your wages, the larger the portion of your preretirement income that Social Security replaces.

Higher-income workers nearing retirement are more likely to be covered by pensions and more likely to be able to have built up a reliable nest egg. Of course, the fading of fixed-benefit pension plans over the past decade has made this source of retirement income much less common than it was a generation ago. Still, some workers nearing retirement—especially those working in the public sector—can count pensions among their sources of retirement income. Others will have built up their own savings through 401(k) or IRA accounts. Indeed, these individual accounts are key components of the nest egg you will want to build.

According to a 2006 report from the Social Security Administration, for the elderly population as a whole the aggregate percentages of retirement income provided by various sources in 2004 were: Social Security, 39 percent; earnings from work, 26 percent; pensions, 19 percent; assets, 12 percent; other, 4 percent.

These amounts represent only statistical aggregates. Individual circumstances will differ. We have provided these figures only as a rough illustration of what some current retirees have experienced, and they may be of some use in your own planning if no other information is available. However, you are advised to estimate as accurately as possible sources of your own income based on your individual circumstances.

How large will your Social Security benefit be? Every year the Social Security Administration sends workers and former workers aged 25 and older an updated estimate of their benefits. If you do not receive yours in the mail, or want another copy, you can get one by phoning Social Security at 1-800-772-1213 and requesting a “Social Security Statement.” A calculator located at the administration’s website ([www.ssa.gov](http://www.ssa.gov)) can also help you figure your benefit.

If you participate in a traditional, fixed-benefit pension plan, you may be able to get an estimate of pension income from your employer.

To give you an idea of how to put all this information together, Table 2 shows hypothetical retirement income sources for a number of different preretirement income levels. Column (1) shows preretirement income, re-

flecting the assumed average gross income of the 10 years before retirement. To estimate your income needs in retirement, you can use the replacement rates listed in Column (2). Multiplying the entries in the first column by the entries in the second gives you the equivalent retirement income, as listed in Column (3).

### *Estimating the Nest Egg*

The next step is to identify how much more, if anything, you need to save to build a nest egg sufficient to pay for your retirement.

Possible sources of expected income appear in columns (4), (5), and (6). These are not necessarily “typical” amounts, but are instead based simply on the aggregates listed earlier for all Social Security retirement beneficiaries in a recent year. On this basis, they list income that would come from Social Security, pensions, and personal earnings and assets.

In place of these hypothetical figures, you are advised to make estimates based on the specifics of your retirement provisions. For example, if you do not have a defined-benefit pension plan, you should leave out the figure for column (5).

How big a nest egg will you need? To begin to derive an answer, column (6), “Earnings and Assets,” shows the gap after Social Security and pension income have been deducted from the retirement income amounts shown in column (3). The amounts in column (6) thus show income that must come from either savings or “post-retirement” employment earnings.

**Table 2: Estimate of Savings Needed to Fund Equivalent Retirement Income at Selected Income Levels**

(1)	×	(2)	=	(3)	(4)	(5)	(6)	(7)
<i>Preretirement Income</i>		<i>Replacement Rate</i>		<i>Equivalent Retirement Income</i>	<i>— Amount Provided by: —</i>			<i>Unadjusted Assets Needed</i>
					<i>Social Security</i>	<i>Pensions</i>	<i>Earnings and Assets</i>	
\$20,000		0.89		\$17,800	\$13,000	\$3,400	\$1,400	\$35,000
30,000		0.84		25,200	16,800	4,800	3,600	90,000
40,000		0.80		32,000	20,400	6,100	5,500	137,000
50,000		0.77		38,500	24,000	7,300	7,200	180,000
<b>60,000</b>		<b>0.75</b>		<b>45,000</b>	<b>25,800</b>	<b>8,600</b>	<b>10,600</b>	<b>265,000</b>
70,000		0.76		53,200	27,300	10,100	15,800	395,000
80,000		0.77		51,600	28,000	11,700	21,900	547,500
90,000		0.78		70,200	29,700	13,500	27,000	675,000

In this discussion we assume that the entire amount required must come from savings. The reason is that while some seniors will want to keep a hand in a business or profession, many others are physically not capable of active work. For planning purposes, therefore, it is prudent not to have to depend on employment earnings in retirement.

The last item, column (7), shows the total amount of assets needed to provide the income flow shown in column (6). Rather than using complicated formulas here, we shall rely on a rule of thumb to provide a good approximation of the nest egg to target.

The rule of thumb provides a conservative rate for you to tap into your nest egg. To be specific, this rate—used in various financial planning software models—suggests an initial withdrawal of only about four percent of your nest egg at 65. Then each year you assume that you withdraw the same amount, adjusted upward for price inflation. This four-percent rule is viewed as a conservative approach that would minimize the risk that you would outlive your savings.

A corollary of the four-percent withdrawal rule is that for any given income component beyond a pension and Social Security, the required nest egg at retirement is 25 times as large. Given the gap, in short, multiply it by 25 to find the nest egg you need.

As an example from Table 3, a person moving from a preretirement income of \$60,000 to a replacement income of \$45,000 has to fill an income gap of \$10,600. The question is, four percent of what initial nest egg equals \$10,600? The answer turns out to be 25 times the needed \$10,600, or \$265,000.<sup>21</sup>

The same multiple can be applied to the income gaps and required nest eggs at other income levels in Table 3. Whatever the annual income gap after taking into account Social Security and any traditional pension benefits, multiply it by 25 to find the required sum. To be clear: there is no guarantee that this sum will be sufficient for your retirement. But it gives you a ballpark figure to work with.

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<sup>21</sup> From high-school algebra, we want to find the amount for the variable NEST-EGG, such that  $.04(\text{NESTEGG}) = \$10,600$ . Dividing both sides by  $.04$ , we get  $\text{NESTEGG} = \$10,600/.04$  or  $\$265,000$ . Dividing the number \$10,600 by four percent ( $.04$ ) to get the nest egg amount is the same as multiplying \$10,600 by  $(1/.04)$ , and  $(1/.04) = 25$ .

### *Converting the Gap Estimate to a Monthly Savings Plan*

Now you need to convert your estimate of required savings into a systematic savings plan. Table 3 lists the “savings factors” that give the amounts to be saved annually if the retirement program is to be fully funded. We list them based on assumed returns on savings of three percent, five percent and seven percent per year. The lower the rate of return, of course, the higher the amount you will have to save each month to meet a specified savings goal.

The example above gave \$265,000 as a target nest egg. If you are now 50, this is the amount that must be attained by the time you reach age 65. To find out how much to save each year, multiply this amount by one of the annual savings factors for a 50-year-old listed in Table 3. If we assume an average

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Table 3: **Annual Savings Factors**

Age	<i>Assuming Annual Investment Yield is:</i>		
	3%	5%	7%
40	0.027	0.020	0.015
41	0.028	0.021	0.016
42	0.030	0.023	0.017
43	0.032	0.025	0.019
44	0.034	0.027	0.021
45	0.036	0.029	0.023
46	0.039	0.031	0.025
47	0.041	0.034	0.027
48	0.045	0.037	0.030
49	0.048	0.040	0.034
50	0.052	0.044	0.037
51	0.057	0.049	0.041
52	0.062	0.054	0.046
53	0.068	0.060	0.052
54	0.076	0.067	0.059
55	0.085	0.076	0.068
56	0.096	0.086	0.078
57	0.109	0.100	0.091
58	0.127	0.117	0.108
59	0.150	0.140	0.131
60	0.183	0.172	0.163
61	0.232	0.221	0.210
62	0.314	0.302	0.291
63	0.478	0.465	0.451
64	0.971	0.952	0.935
65	1.000	1.000	1.000

investment return of seven percent per year, for example, the corresponding savings factor for a 50-year old is .037. Multiplying \$265,000 x .037 gives an annual savings requirement of \$9,805, or about \$820 a month.

Note that if you are now 40 years old, you would need to set aside far less: \$3,975 per year, or about \$330 per month. This underscores the benefit of setting aside savings as early as you can and letting the “miracle of compounding” help you reach your goal.

To recap, you can estimate your target nest egg at the beginning of your retirement (at age 65) by multiplying your estimated income gap by 25. Then you can find the annual savings needed to reach this goal by multiplying the target nest egg by an annual savings factor from one of the three columns in Table 3.

Given your age, you can assume different investment rates of return to estimate how much you need to save annually to reach that goal. The worksheets at the end of this chapter may help in your calculations.

### *Using an Online Calculator To Test Your Plan’s Adequacy*

A valuable self-help tool for thinking about your retirement plan is a retirement calculator, as offered on various online websites, such as [www.dinkytown.com](http://www.dinkytown.com). You will be asked to provide data about your age,

<i>Current age</i>	56	<i>Household income</i>	\$100,000
<i>Rate of return before retirement</i>	6%	<i>Age of retirement</i>	65
<i>Rate of return during retirement</i>	5%	<i>Expected salary rise</i>	0%
<i>Years until retirement</i>	9	<i>Years of retirement</i>	25
<i>Percent of income at retirement</i>	80%	<i>Current savings</i>	\$500,000
<i>Percent of income to contribute</i>	8%	<i>Expected inflation</i>	3.1%
<i>Your last year’s income</i>	\$100,000	<i>Retirement budget</i>	\$80,000
<i>Include Social Security?</i>	“Yes”	<i>Are you married?</i>	“Yes”

savings, preferred retirement age, marital status, and the like. Once you enter these and a few other numbers (including assumed rates of price inflation and returns on investments), the calculator will map out a trajectory for your retirement account to test its adequacy.

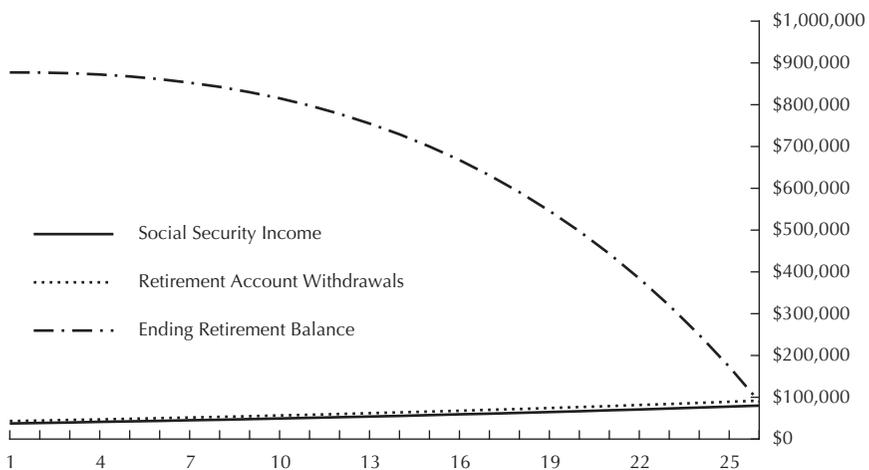
In the box on page 74 is an example from [dinkytown.com](http://dinkytown.com) for a person nine years away from retirement who provided the requested data.

The conclusion that pops out on the website: “Your ending balance is \$89,585.” Under the assumptions entered above, the accumulated savings at the age of 65 plus Social Security benefits would pay an annual income (adjusted for inflation) of \$80,000 for 25 years. At that point, in the dry language of the calculator site, you “end” your retirement, leaving a balance for your heirs of about \$90,000.

Chart 2 and Table 4 illustrate the logic behind this estimate. For the hypothetical individual in the chart, retirement savings peak when he is 65 (at \$877,000). At this point he stops earning income from employment—and he is assumed to stop saving for retirement. Meantime he begins drawing Social Security. Given his high lifetime earnings and his marital status, he is projected to receive the maximum estimated benefit of just over \$37,000.

The replacement rate of income we have entered in this example is 80 percent of his last year’s salary, which works out to \$80,000. In round numbers the

Chart 2: A 25-Year Retirement Simulation



Source: Simulation on [dinkytown.com](http://dinkytown.com).

gap between his desired retirement income and his Social Security payments is \$43,000 (or \$80,000 - \$37,000). In his first year of retirement, at 65, that gap is filled by a withdrawal from his retirement account of the same amount.

Each year thereafter, until his assumed death at 90, his spending and his Social Security payment are assumed to go up apace with inflation (assumed to be 3.1 percent per year). The amount that must bridge the gap between the two is filled by a withdrawal from the pool of retirement savings. According

Table 4: 25-Year Retirement Simulation

Age	Beginning Retirement Balance	Investment Growth	Contributions: 8% of Income	Retire with 80% of Income	Social Security Income	Retirement Account Withdrawals	Ending Retirement Balance
57	\$500,000	\$30,000	\$8,000	\$0	\$0	\$0	\$538,000
58	538,000	32,280	8,000	0	0	0	578,280
59	578,280	34,697	8,000	0	0	0	620,977
60	620,977	37,259	8,000	0	0	0	666,235
61	666,235	39,974	8,000	0	0	0	714,210
62	714,210	42,853	8,000	0	0	0	765,062
63	765,062	45,904	8,000	0	0	0	818,966
64	818,966	49,138	8,000	0	0	0	876,104
65	876,104	43,805	0	80,000	37,227	42,773	877,136
66	877,136	43,857	0	82,480	38,381	44,099	876,894
67	876,894	43,845	0	85,037	39,571	45,466	875,273
68	875,273	43,764	0	87,673	40,798	46,875	872,162
69	872,162	43,608	0	90,391	42,063	48,328	867,442
70	867,442	43,372	0	93,193	43,367	49,826	860,988
71	860,988	43,049	0	96,082	44,711	51,371	852,666
72	852,666	42,633	0	99,061	46,097	52,964	842,336
73	842,336	42,117	0	102,131	47,526	54,605	829,847
74	829,847	41,492	0	105,297	48,999	56,298	815,041
75	815,041	40,752	0	108,562	50,518	58,043	797,750
76	797,750	39,887	0	111,927	52,084	59,843	777,794
77	777,794	38,890	0	115,397	53,699	61,698	754,986
78	754,986	37,749	0	118,974	55,364	63,611	729,125
79	729,125	36,456	0	122,662	57,080	65,582	699,999
80	699,999	35,000	0	126,465	58,849	67,616	667,383
81	667,383	33,369	0	130,385	60,674	69,712	631,041
82	631,041	31,552	0	134,427	62,555	71,873	590,720
83	590,720	29,536	0	138,594	64,494	74,101	546,155
84	546,155	27,308	0	142,891	66,493	76,398	497,065
85	497,065	24,853	0	147,321	68,554	78,766	443,152
86	443,152	22,158	0	151,887	70,680	81,208	384,102
87	384,102	19,205	0	156,596	72,871	83,725	319,582
88	319,582	15,979	0	161,450	75,130	86,321	249,240
89	249,240	12,462	0	166,455	77,459	88,997	172,705
90	172,705	8,635	0	171,616	79,860	91,756	89,585

to this simulation, “Your plan is on track.” That means that his retirement savings will carry him through to the age of 90, with something left over.

### *What if Something Goes Wrong?*

Of course any number of things could interfere with this rosy scenario. It is based on a multitude of assumptions that may not prove accurate. We can focus on three of the most likely pitfalls: higher inflation, the need for long-term care and outliving the plan.

What if the assumed rate of price inflation is too low? The rate we entered into the calculator, 3.1 percent a year, is the rate suggested on the website, because that was the average rate from 1925 to 2005. Others would suggest a rate of 3.5 percent, roughly the average for the last few years. But even that might be too low, if only because medical costs have recently been increasing twice as fast (seven percent a year) as the general price level, and Medicare may not shield you fully. In that case, your expenses could well rise more rapidly, straining your budget.

Second, the plan has made no provision for long-term care, whether in an assisted-living facility, a nursing home or in your own home. Since current annual costs of nursing-home care average \$73,000 nationwide (and range much higher in some regions), a severe disability can throw otherwise prudent plans into disarray. This long-term-care contingency is discussed more fully in our book, *How to Plan for Your Retirement Years*.<sup>22</sup> In brief, the point suggested there is that recent changes in Medicaid law make *long-term-care insurance* a more attractive feature of a retirement plan than in the past.

Third, what if you are lucky enough to outlive the plan’s payouts? Suppose you live to be 95, not 90? Under the trajectory in Chart 2, you may well have depleted your retirement savings account by then, leaving a big deficit in your budget for each additional year you live.

The implication is that you may wish to take out a kind of insurance policy to hedge against such surprises. The simplest way to do this is to buy a fixed annuity, which is sometimes described as a “do-it-yourself pension.”

Here as well, we treat the pros and cons of various types of annuities in *How to Plan for Your Retirement Years*. The point for now is simply that a well-designed and carefully researched fixed annuity can provide a solution to the problem of outliving your nest egg.

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<sup>22</sup> See the inside of the back cover of this book for more details regarding AIER’s publications.

## Worksheet

### Part A

#### TOTAL PERSONAL SAVINGS NEEDED FOR RETIREMENT

A	Estimated Gross Preretirement Income .....	_____
B	Replacement Rate (Table 3, Column 2) .....	_____
C	Equivalent Retirement Income (line A × line B) .....	_____
D	Estimated Annual Income from Social Security (Monthly Benefit × 12)* .....	_____
E	Estimated Annual Pension Income (if any) .....	_____
F	Estimated Annual Income needed from Savings (line C – line D – line E) .....	_____
G	Estimated Unadjusted Total Personal Savings needed (line F × .25)** .....	_____

\* From the “Personal Earnings and Benefit Estimate Statement,” available from the Social Security Administration.

\*\* As explained in the text, a multiple of 25 corresponds to an annual inflation-adjusted withdrawal of four percent.

**Part B**

**ESTIMATED REQUIRED ANNUAL SAVINGS\***

<i>(a)</i> Age Saving Begins	<i>(b)</i> Unadjusted Savings from line G	<i>(c)</i> Savings Factor from Table 4	<i>(d)</i> Annual Savings [line G × (c)]	<i>(e)</i> Monthly Savings
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____

Note: We have provided space here for you to enter a number of estimates based on different assumptions respecting your income, the age when you begin saving, inflation rates, etc.



## APPENDIX

### SOCIAL SECURITY: WHAT IT IS, HOW IT WORKS

**E**NACTED during the Great Depression, Social Security was partly a response to widespread poverty among the aged. Social Security sought to prevent poverty in old age by replacing some of the labor income lost upon retirement, and thereby provide a minimum floor or, in President Roosevelt’s words, “some measure” of protection for the aged. It also sought to encourage retirement so as to enable unemployed younger Americans to obtain jobs then held by older ones. Finally, it was intended to promote unionization by removing the need for unions to provide old-age benefits for members, thus enabling unions to charge lower dues and making it easier to recruit more members.

#### *Essential Nature*

Social Security is an example of “social insurance.” As discussed in the box on p. 7, social insurance is essentially welfare without a means test. The rationale for Social Security is *social equity*—the notion that a society needs to support those who for one reason or another cannot support themselves—which is also the rationale for welfare. But unlike welfare, Social Security benefits are paid to those who demonstrate conditions (such as reaching retirement age after gainful employment for a specified period of time) rather than need.

That the level of Social Security benefits payable to a given individual is related to that individual’s work history gives the program some of the trappings of insurance: it demonstrates *individual equity* in the sense that what an individual gets out of the program is related to what he or she put in.

The fundamental principles of social equity and individual equity conflict. Individual equity is at the core of private insurance, whereas social equity is inspired by some ideological notion of social justice and entails redistribution. A benefit level, especially for a lower-income person, that satisfies one principle will likely violate the other.

#### *Taxes*

Social Security’s main source of funding is taxes on labor income, up to a ceiling known as the “maximum income subject to tax,” “maximum

taxable income” or “contribution and benefit base.” Labor income above this ceiling is neither subject to the OASDI tax nor creditable for purposes of computing benefits. Repeatedly raised by Congress in past years, the maximum income subject to tax is now increased automatically every year to reflect increases in average wages. Beginning in 1937, a payroll tax was levied on the labor incomes of employees in occupations covered by Social Security, matched dollar for dollar by excises levied on their employers. The employee payroll taxes are known as FICA taxes, after the Federal Insurance Contribution Act (FICA). Beginning in 1951, the self-employed have also participated in Social Security, and pay a self-employment (SE) tax on their self-employment income. The initial SE tax rate was higher than the employee’s FICA rate but less than the sum of the employee’s and employer’s tax rates. In 1983 the SE rate was raised to 100 percent of the sum of the employee and employer FICA rates.

The Social Security tax, all economists agree, is regressive—that is, extracting a higher proportion of lower incomes and a decreasing share as income rises. The tax is imposed at a flat rate up to the maximum taxable income. Since the ceiling has been increased enormously, the regressivity with respect to labor income has diminished slightly. But overall, the tax remains regressive, as its burden on very high labor incomes is minuscule. Moreover, interest, rent, profits, capital gains, other nonlabor income and fringe benefits, which are received mostly by high-income persons, are not taxed by Social Security, further contributing to the regressivity of the tax.

Economists also generally agree that the employer’s share of the payroll tax is really borne by worker. This tax shifting can occur either through lower money wages and fringe benefits than the worker would have received otherwise, or (sometimes) through higher prices and profits, *i.e.*, lower real wages. Employers are able to shift their share of the tax to their workers because the aggregate supply of labor is very inelastic with respect to the Social Security tax—workers will not quit if the Social Security tax increases. Thus, when an employer’s labor cost entailed by hiring a worker is increased because of the Social Security tax, he can offer the same amount of employment only by making an offsetting reduction in money wages and fringe benefits. Over the long run, then, the worker pays the employer’s share of the Social Security tax by accepting lower wages than he would have received otherwise.

Social Security’s initial tax rate was quite modest, only one percent of

**Table 1: Tax Rates, Maximum Taxable Income, Sample Taxes, 1937-2007**

<i>Calendar year</i>	<i>Maximum taxable income</i>	<i>Employee (FICA) tax rate</i>	<i>Self-employed tax rate</i>	<i>FICA tax \$20,000 income</i>	<i>SE tax \$20,000 income</i>	<i>Maximum employee (FICA) tax</i>
1937-1949	\$3,000	1.000	—	\$30.00	—	\$30.00
1950	3,000	1.500	—	45.00	—	45.00
1951-1953	3,600	1.500	2.250	54.00	\$81.00	54.00
1954	3,600	2.000	3.000	72.00	108.00	72.00
1955-1956	4,200	2.000	3.000	84.00	126.00	84.00
1957-1958	4,200	2.250	3.375	94.50	141.75	94.50
1959	4,800	2.500	3.750	120.00	180.00	120.00
1960-1961	4,800	3.000	4.500	144.00	216.00	144.00
1962	4,800	3.125	4.700	150.00	225.60	150.00
1963-1965	4,800	3.625	5.400	174.00	259.20	174.00
1966	6,600	3.850	5.800	254.10	382.80	254.10
1967	6,600	3.900	5.900	257.40	389.40	257.40
1968	7,800	3.800	5.800	296.40	452.40	296.40
1969-1970	7,800	4.200	6.300	327.60	491.40	327.60
1971	7,800	4.600	6.900	358.80	538.20	358.80
1972	9,000	4.600	6.900	414.00	621.00	414.00
1973	10,800	4.850	7.000	523.80	756.00	523.80
1974	13,700	4.950	7.000	653.40	924.00	653.40
1975	14,100	4.950	7.000	697.95	987.00	697.95
1976	15,300	4.950	7.000	757.35	1,071.00	757.35
1977	16,500	4.950	7.000	816.75	1,155.00	816.75
1978	17,700	5.050	7.100	893.85	1,256.70	893.85
1979	22,900	5.080	7.050	1,016.00	1,410.00	1,163.32
1980	25,900	5.080	7.050	1,016.00	1,410.00	1,315.72
1981	29,700	5.350	8.000	1,070.00	1,600.00	1,588.95
1982	32,400	5.400	8.050	1,080.00	1,610.00	1,749.60
1983	35,700	5.400	8.050	1,080.00	1,610.00	1,927.80
1984	37,800	5.700	11.400	1,140.00	2,280.00	2,154.60
1985	39,600	5.700	11.400	1,140.00	2,280.00	2,257.20
1986	42,000	5.700	11.400	1,140.00	2,280.00	2,394.00
1987	43,800	5.700	11.400	1,140.00	2,280.00	2,496.60
1988	45,000	6.060	12.120	1,212.00	2,424.00	2,727.00
1989	48,000	6.060	12.120	1,212.00	2,424.00	2,908.80
1990	51,300	6.200	12.400	1,240.00	2,480.00	3,180.60
1991	53,400	6.200	12.400	1,240.00	2,480.00	3,310.80
1992	55,500	6.200	12.400	1,240.00	2,480.00	3,441.00
1993	57,600	6.200	12.400	1,240.00	2,480.00	3,571.20
1994	60,600	6.200	12.400	1,240.00	2,480.00	3,757.20
1995	61,200	6.200	12.400	1,240.00	2,480.00	3,794.40
1996	62,700	6.200	12.400	1,240.00	2,480.00	3,887.40
1997	65,400	6.200	12.400	1,240.00	2,480.00	4,054.80
1998	68,400	6.200	12.400	1,240.00	2,480.00	4,240.80
1999	72,600	6.200	12.400	1,240.00	2,480.00	4,501.20
2000	76,200	6.200	12.400	1,240.00	2,480.00	4,724.40
2001	80,400	6.200	12.400	1,240.00	2,480.00	4,984.80
2002	84,900	6.200	12.400	1,240.00	2,480.00	5,263.80
2003	87,000	6.200	12.400	1,240.00	2,480.00	5,394.00
2004	87,900	6.200	12.400	1,240.00	2,480.00	5,449.80
2005	90,000	6.200	12.400	1,240.00	2,480.00	5,580.00
2006	94,200	6.200	12.400	1,240.00	2,480.00	5,840.40
2007	97,500	6.200	12.400	1,240.00	2,480.00	6,045.00

Source: 2007 OASDI Annual Report.

labor income up to a maximum taxable income of \$3,000, for a maximum annual tax of \$30.00. Coverage of the labor force has been repeatedly expanded, and the program repeatedly liberalized since 1935. Its need for revenue has risen accordingly. Congress has three options for increasing OASDI revenues: expand the population of workers covered by Social Security, *i.e.*, paying taxes (and eventually getting benefits); increase the tax rate; and raise the maximum income subject to tax. Congress has repeatedly done all three. As of 2007, 162 million members of the labor force paid Social Security taxes; the FICA tax rate stood at 6.2 percent (the employer paying another 6.2 percent); the self-employment tax rate was 12.4 percent; and labor income up to \$97,500 was subject to tax.

The payroll tax has become large enough to have significant pernicious economic effects. As Table 1 shows, the tax load has become heavy even for such modest labor incomes as \$20,000, and has become especially punishing for the self-employed. It follows that one very important effect of the soaring Social Security tax has been to make it extremely difficult for working Americans, especially those of modest incomes, to do substantial saving and investing for their old age. It has also become a major disincentive to self-employment and creation of small businesses.

Also, at its current level of 12.4 percent of taxable payroll (or 15.3 percent if we include the 2.9 percent of taxable payroll used to fund Medicare's Hospital Insurance), the payroll tax is a significant barrier to employment. It is the largest part of the "wedge" between what it costs an employer to take on an employee and what the employee actually gets.<sup>23</sup> Plant and equipment that can substitute for human labor are not subject to the payroll tax, nor, more to the point, is the capital used to finance them. Finally, it is a major reason why many low-wage workers choose to be "off the books," foregoing the protection of the labor laws, unemployment insurance, etc.

### *"Insured Status" and Eligibility for Benefits*

Social Security provides monthly benefits to retirees, dependents, widows, spouses, and divorced spouses. "Insured status," or meeting the eligibility requirements for receiving retiree or disability benefits, or per-

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<sup>23</sup> The other components of the "wedge" that are mandated by the government include workmens' compensation insurance and unemployment insurance taxes. In contrast to Social Security taxes, these payments are related to the nature of the business, and the benefits paid are related to the worker's employment experience.

mitting your children, spouse or survivors to become eligible for benefits in the event of your disability, retirement or death, is based on “quarters of coverage.” A quarter of coverage (QC) is earned not merely by working for a calendar quarter in a covered occupation, up to a total of four per year, but by earning a certain amount. For years before 1978, an employee received one quarter of coverage for each calendar quarter in covered employment in which at least \$50 was earned. In 1978 this was changed to one QC for every \$250 in annual earnings. Earnings needed to receive a quarter of coverage increase automatically each year in proportion to increases in average wages. In 2007, a worker received one quarter of coverage for every \$1,000 of annual covered earnings.

There are three different categories of “insured status:” “currently insured,” “fully insured” and “disability insured.” So-called currently insured status is acquired by any worker who has accumulated six QCs in the 13-quarter period ending with the current quarter. To be “fully insured,” you must have at least six quarters of coverage, and your total number of QCs must equal or exceed the number of years elapsed since you turned 21. Once you have accumulated 40 QCs, you are permanently “fully insured.” “Disability insured” status is acquired by any fully insured worker over age 30 who has accumulated 20 QCs in the 40-quarter period ending in the current quarter; by any fully insured worker aged 24-30 who has accumulated QCs during half of the quarters in the period from the quarter in which age 21 was attained up to and including the current quarter; and by any fully insured worker under 24 who has accumulated six quarters of coverage in the 12-quarter period ending with the current quarter.

One requirement, but not the only one, for eligibility for benefits is the insured status of the worker. A worker must be “fully insured” to qualify for the primary retirement benefits, and for his or her spouse to be eligible for auxiliary benefits. A deceased worker must have been either currently insured or fully insured at the time of death for his or her children (and their mother or father) to be eligible for survivors benefits. If there are no eligible surviving children, the deceased worker must have been fully insured at the time of death for his or her surviving spouse to be eligible for survivors benefits. A worker must be disability insured to be eligible for a primary disability benefit, and for his or her spouse to qualify for auxiliary disability benefits.

For those who qualify for benefits as spouses, widows, divorced spouses

and dependents, benefits may not be available until either the beneficiary or the worker reaches a certain age, and there are various other conditions that must be met. If you fall into one of these categories, regardless of your income, it may pay to check with your local Social Security office about your possible eligibility for benefits. A surprising number of eligible people do not collect benefits simply because they did not know they were eligible and never thought to apply for them.

Social Security does not pay benefits automatically as soon as you become eligible. To begin collecting benefits, you must file an application. You should plan to do so about two months in advance, and have a copy of your birth certificate. The process may take longer and require more paperwork for the self-employed. For information on filing, or any other Social Security question, you can call the Social Security Administration toll-free at 1-800-772-1213 or check its website, [www.ssa.gov](http://www.ssa.gov).

### ***Retirement Benefits***

Benefit calculation begins by reviewing your annual earnings history, as indicated by your payroll tax records, for the years prior to your 62nd birthday. During Social Security's early years, average annual earnings essentially were figured by adding up annual credited earnings and divided the total by the number of years worked. But chronic postwar price inflation led to inflated nominal earnings from one's later working years being lumped together with smaller nominal earnings from earlier years. Accordingly, when inflation accelerated in the 1970s, Congress mandated that calculation of average annual earnings include an adjustment for this distortion. Earnings for a given year are now multiplied by an "index factor" for that year, reflecting year-by-year changes in the national average wage, to bring them up to their approximately equivalent value at the time of eligibility for benefits.

The most notable feature of this provision is that because nominal wages have increased faster than prices in the postwar years, the adjustment is far more generous than one based on price inflation. In the 1951-1994 period, for example, the national average wage increased about eightfold, so in the 1994 benefit calculations, 1951 wages were multiplied by a factor of eight to make them comparable to 1994 wages. During this period the consumer price index increased "only" about fivefold. Clearly, this adjustment overstates "real" earnings. Consequently, it inflates the benefits based on those

earnings, and thus makes Social Security more costly than it would be if earnings were adjusted only for price inflation.

Once one's annual earnings have been indexed, the Average Indexed Monthly Earnings (AIME) can be calculated. The period used to calculate your AIME equals the number of full calendar years elapsing between the year you turned 21 (or 1950, if later) and the year of your first eligibility, usually excluding the lowest five years. In other words, only your 35 highest years of indexed earnings are averaged. Thus, if your real earnings had increased steadily over your career, only the last 35 years count. AIME is calculated as the sum of indexed earnings in this period, divided by the number of months in that period.

The monthly benefit payable to a retired worker who begins receiving benefits at the "normal retirement age" (NRA)—the earliest age at which one becomes entitled to full retirement benefits—or (generally) a disabled worker, is known as the Primary Insurance Amount (PIA). The PIA is calculated according to a formula breaking up the AIME into ranges bounded by dollar amounts called "bend points," and replacing smaller shares of the AIME as the income level rises. Thus the PIA is 90 percent of the AIME below the first bend point, plus 32 percent of the AIME above the first bend point but below the second, plus 15 percent of the AIME above the second bend point. These percentages are fixed, but the dollar amounts of the bend points increase every year, based on the increase in the national average wage. This is done to ensure that benefits levels keep up with wage increases, so that rates of earning replacement are consistent across generations of beneficiaries. For 2007 the first bend point was \$680 and the second was \$4,100.

The benefit formula depends on the year of eligibility or death, not on the year benefits are first received. Thus if you retired at 65 in 2007, your PIA is determined using the benefit formula that applies to all workers first eligible in 2004 (the "year of attainment" of age 62). The resultant PIA is then augmented by the COLAs effective for December of 2004, 2005 and 2006 to determine the PIA effective at age 65.

From the PIA formula, it is clear that benefits are progressive, replacing ever smaller shares of income as it rises. For 2007, the PIA replaces \$90 of every \$100 in labor income up to \$680, replaces \$32 of every \$100 in income between \$680 and \$4,100, and replaces \$15 of every \$100 in income above \$4,100. The PIA formula is thus the great leveler of the Social

Security system, which makes the program highly progressive despite the regressivity of its taxes. People with higher incomes do get larger benefits, but only marginally so in relation to taxes paid.

Table 2 illustrates the progressivity of Social Security benefits by presenting estimated annual benefits for retirees turning 65 in 2007 with various earning patterns: low (career-average earnings assumed equal to about 45 percent of the Average Wage Index), medium (career-average earnings about 100 percent of AWI), high (career-average earnings about 160 percent of the AWI), and maximum (each year’s earnings equal to the maximum taxable income). For those with earnings above the maximum taxable income, benefits replace an even smaller share of total earnings.

The PIA formula also makes it unmistakably clear that contrary to popular belief and to misleading depictions of Social Security in many quarters, your Social Security benefits are *not* based on your Social Security taxes. Rather, your benefits are based on your lifetime *earnings*.

Most benefits differ from the PIAs on which they are based for a variety of reasons. Your monthly benefits will exactly equal your PIA only if you retire upon attaining the “normal retirement age” (NRA), are unmarried with no dependents, and do not receive certain other government pensions.

The normal retirement age, also know as the “retirement age,” was fixed at 65 by the Social Security Act of 1935, and remained there until very recently. However, under the Social Security Amendments of 1983, the retirement age is being gradually raised. Beginning in 2003, the retirement age rose by two months per year, reaching 66 in 2005 and remaining there until 2016, when it will begin rising again in two-month increments until 2022, to age 67 for those turning 62 in 2022, *i.e.*, to 67 in 2027.

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**Table 2: Estimated Annual Benefit Amounts for Retired Workers With Various Preretirement Earnings Patterns, Calendar 2007**  
(benefits in 2007 dollars)

<i>Earnings</i>	<i>Retirement at NRA (65 yrs. 6 mos.)</i>		<i>Retirement at age 65</i>	
	<i>Annual benefit</i>	<i>Percent of earnings</i>	<i>Annual benefit</i>	<i>Percent of earnings</i>
Low	\$9,921	56.0	\$9,443	54.2
Medium	15,361	41.5	15,570	40.2
High	21,640	34.6	20,604	33.5
Maximum	25,213	28.5	24,004	27.9

Source: 2007 OASDI Annual Report.

Retirement at the normal retirement age is not mandatory. You may retire early and collect benefits permanently reduced from the full retirement level by  $\frac{5}{9}$  of 1 percent for each month before age 65 that you retire. Thus if your NRA is 65 and you retire at age 62, your benefit will be permanently reduced by 20 percent (*i.e.*, your PIA for the rest of your life will be 80 percent of what your PIA would have been had you retired at 65). If, for example, you would be entitled to a monthly benefit of \$600 at age 65, if you retire at age 62 you will receive \$480 a month; if you retire at age 64, your benefit will be \$560. The 1983 legislation also mandated that beginning in 2000, early retirement benefits would still be available at age 62, but will as a smaller share of the full retirement benefit. For those born in 1938 and after, benefits collected earlier than age 64 are permanently cut an additional  $\frac{5}{12}$  of one percent for each month under age 64. The effect is to gradually trim early retirement benefits from 80 percent of the PIA in 2003 to 70 percent in 2027.

Also, you can retire later and get larger benefits. If you wait until after 65, you receive a credit of a certain percentage of the PIA for each year you delay retirement until age 70, and your benefit increases accordingly. However, under the 1983 legislation, both early and delayed retirement benefits are declining shares of the PIA for workers born in 1938 or later. Table 3 summarizes the legislated changes in the NRA and in early retirement and delayed retirement benefits.

There are numerous other adjustments, such as increases in benefits for those with spouses and/or dependents (see the section on family retirement benefits below), or (since the 1983 legislation) reductions in monthly benefits for those receiving other government pensions. The upshot of these adjustments is that your monthly benefit check can range from a fraction of your PIA to more than twice the PIA. *However, these adjustments are only coincidentally related either to the needs of the beneficiaries or to the finances of the system; i.e., they are essentially arbitrary.*

### ***The Retirement Earnings Test***

To receive benefits, retirees must also meet the Social Security “retirement earnings test” (also known as the “earnings test”). The original Social Security Act stipulated that retirement benefits would be lost completely for any month in which the beneficiary had income from employment covered by the Act.

The retirement earnings test served the goal of removing older workers from the labor force so unemployed younger workers could get jobs. It also helped contain the cost of Social Security. However, it conflicted with Social Security's official characterization as an annuity program paying benefits as an earned right without a means test. The retirement earnings test functioned just like a means test, of course, since it denied benefits to those who had means of their own in the form of earnings from covered employment.

Bitterly resented by the elderly, the retirement earnings test was repeatedly liberalized. Congress first amended it so that retirees could earn up to \$15 a month before losing benefits. In 1950 Congress relaxed the retirement earnings test still further, raising the earnings limit to \$50 a month and exempting beneficiaries aged 75 or older. The age provision was gradually liberalized; in 1955-1982, the retirement earnings test did not apply at age 72 and over; and in 1983-1999, it did not apply at ages 70 and over.

The limit on earnings was also repeatedly liberalized. After price inflation accelerated in the 1970s it was tied to increases in average wages, and Congress periodically legislated additional increases. Moreover, the rate

**Table 3: Legislated Changes in Normal Retirement Age, Early Retirement Benefits, and Delayed retirement Credits for Persons Reaching Age 62 in 1986 and Later**

Year of birth	Year of turning age 62	Normal retm't age (y:m)	% PIA credit per yr. delayed retm't	Benefit as % of PIA, beginning at age:				
				62	65	66	67	70
1924	1986	65	3	80	100	103	106	115
1931	1993	65	5	80	100	105	110	125
1937	1999	65	6½	80	100	106½	113	132½
1938	2000	65:2	6½	79⅙	98⅘	105⅝ <sub>12</sub>	111 <sup>11</sup> / <sub>12</sub>	131⅝ <sub>12</sub>
1939	2001	65:4	7	78⅓	97⅘	104⅔	111⅔	132⅔
1940	2002	65:6	7	77½	96⅔	103½	110½	131½
1941	2003	65:8	7½	76⅔	95⅘	102½	110	132½
1942	2004	65:10	7½	75⅝	94⅘	101¼	108¾	131¼
'43-'54	'05-'16	66	8	75	93⅓	100	108	132
1955	2017	66:2	8	74⅙	92⅘	98⅘	106⅔	130⅔
1956	2018	66:4	8	73⅓	91⅘	97⅘	105⅓	129⅓
1957	2019	66:6	8	72½	90	96⅔	104	128
1958	2020	66:8	8	71⅔	88⅘	95⅘	102⅔	126⅔
1959	2021	66:10	8	70⅔	87⅘	94⅘	101⅓	125⅓
1960 +	2022 +	67	8	70	86⅔	93⅓	100	124

Source: 2007 OASDI Annual Report.

of reduction in benefits was lowered until by 1978 benefits were cut by \$1 for every \$2 in earnings above the earnings limit. In 1990 it became \$1 for every \$3 above the limit for beneficiaries aged 65 to 69.

In 2000, Congress abolished the retirement earnings test for persons above the full retirement age. It remains in force for beneficiaries below the full retirement age; in 2007, a beneficiary below the retirement age could earn \$12,960 without losing benefits.

### *Family Retirement Benefits*

When you retire, your spouse is entitled to a spousal benefit, equal to 50 percent of your PIA if he or she is at least 65. Alternatively, a spouse can apply for this benefit any time after reaching age 62, but it will be permanently reduced by  $\frac{25}{36}$  of one percent for each month by which the spouse's age is under the normal retirement age. Thus, if the NRA is 65 and the spouse elects to collect benefits at 62, they will be reduced by 25 percent. (This works out to a benefit equal to 37.5 percent of the PIA:  $0.50$  of the PIA  $\times .75 = .375$ ) In any case, no spousal benefit is payable until the retiree's benefits begin.

The "spousal" allowance, normally 50 percent of one's PIA (less if the spouse is under 65), is one of the more bizarre aspects of the system. If the sum of a retired couple's PIAs exceeds 150 percent of the larger PIA, the couple can receive more "living in sin" than in wedlock, and some elderly couples live thus for that very reason.

Families may be eligible for an even larger retirement benefit. A spouse caring for a child under age 16 is eligible to collect spousal benefits at any age, with no reduction for the spouse's age. Dependent children under 18 (19, if in high school) or permanently disabled are also eligible to collect benefits equal to 50 percent of the retiree's full benefit.

There is a maximum family benefit, which is based on the worker's PIA. Like all OASDI benefits, it is adjusted annually for inflation. The maximum family benefit is higher for retirement and survivor cases than for disability cases. In retirement and survivor cases the maximum is about 175 percent of the individual's PIA—between 150 and 188 percent for low-wage earners. In disability cases, family benefits are limited to the smaller of 85 percent of the Average Indexed Monthly Earnings (or 100 percent of the PIA, if larger) and 150 percent of the PIA, but in no case is it less than 100 percent of the PIA payable to the disabled worker alone.

The maximum family benefit formula applicable to a worker depends on the year of attainment of age 62, onset of disability, or death. After the maximum family benefit for the year of first attainment is determined, it is adjusted with COLAs.

### ***Survivor Benefits***

Survivor benefits are available to spouses at virtually any age if they have young children, to dependent elderly parents, and to younger children as well, provided the deceased met the “insured status” requirements mentioned earlier. There is also a small lump-sum death benefit. Survivors of a deceased worker should always investigate their eligibility; never assume that you do not qualify because of income or other circumstances.

Of particular interest to retirement planners, a surviving spouse can claim a benefit based on the deceased’s Social Security record as early as age 60. A benefit equal to the deceased’s PIA is available only if the spouse waits until age 65 to claim it. Benefits claimed between ages 60 and 65 are reduced permanently, on a sliding scale. For a 62-year old widow(er) the benefit is 82.9 percent of the full benefit; for a 60-year-old it is 71.5 percent.

### ***Disability Benefits***

For Social Security purposes, disability is defined as the inability to engage in substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to last for a continuous period of not less than 12 months. Special rules apply for workers aged 55 and over who are disabled due to blindness. Generally, the law requires that a person be disabled continuously for five months before he or she can be eligible for disability benefits. Determination of disability is often difficult. Clear-cut cases of disability include terminal cancer, serious heart conditions, or loss of the use of limbs; such cases constitute about 75 percent to 80 percent of all disability claims awarded. Since 1980, the status of disability beneficiaries is supposed to be reviewed every three years, unless the beneficiary has been determined to be permanently disabled.

Disability benefits include benefits to the disabled worker, to his (her) spouse and children; disabled widow(er)’s benefits and childhood disability benefits. The disability benefit is equal to 100 percent of the disabled worker’s PIA, computed as though he had attained 62 during the first month of his disability. Therefore, the amount of the disability benefit is the same

as the normal retirement benefit, if the average earnings on which they are based are the same. Average earnings will depend, however, on the time of the onset of disability, and therefore so will the benefit. In some cases, total disability benefits paid to the worker and his dependents may be reduced if he is also receiving worker's compensation benefits.

One's disability benefit ends on the month preceding the earliest of (a) the month in which he dies, (b) the month in which he attains the NRA and therefore becomes eligible for full retirement benefits, or (c) the third month after the month in which the disability ceases.

Table 4 gives details of the various retirement, survivor, and disability benefits.

### ***Special Minimum Benefit***

Workers who have long work histories under Social Security with very low earnings may be eligible for a special minimum benefit, based on a special minimum PIA computation. This computation depends not on the worker's earnings but on the number of "years of coverage" over 10 and up to 30. A "year of coverage" is one in which the worker had earnings at or above a specified amount—25 percent of the maximum taxable income for years 1951-1978, about 18.7 percent of the maximum taxable income for years 1979-1990, and 11.2 percent in subsequent years. The level of the special minimum PIA is the same for workers having the same number of years of coverage, regardless of age or year of first eligibility. Increases in the special minimum PIA are tied to the COLA.

Under these provisions, a worker with 11 years of coverage qualified for a special minimum benefit of \$34.20 per month in 2006. The monthly benefit increases proportionately as the years of coverage increase. For example, 20 years of coverage yield an approximate monthly benefit of \$342.00 for 2006, while 30 or more years generate a monthly benefit of \$682.70.

### ***Limitations on Benefits***

If you are simultaneously entitled to more than one Social Security benefit, only the highest benefit will be paid. For example, a woman entitled to an old-age benefit based on her own earnings record, and a wife's or widow's benefit based on her husband's earnings record, will receive only the larger of the two. She actually receives her own benefit plus a supplement to make up for the difference. Also, an eligible remarried widow(er)

Table 4: **OASDI Benefits by Benefit Type and Beneficiary Type, with Eligibility Requirement and Benefit Size**

Type, Beneficiary		Worker's Insured Status	Benefit (as percent of PIA)
<b>Old-Age</b>			
Worker	Retired worker, 62 or over	Fully	100*
Spouse	Retiree's spouse, 62 or over	Fully	50*
	Retiree's spouse, caring for worker's child under 16, or disabled child, if disabled before 22	Fully	50
	Divorced wife (in some cases if 62 or over and at least 10 years of marriage)	Fully	50
Child	Retired worker's child under 18**	Fully	50
<b>Survivors</b>			
Spouse	Widow(er) 60 or over (including surviving divorced wife in some cases), 50 if disabled	Fully	100*
	Widow(er) caring for deceased worker's child under 16, or disabled child, if disabled before 22	Fully or Currently	75
Child	Deceased worker's dependent, unmarried child under age 18,** or regardless of age if disabled before 22	Fully or Currently	75
Parent	62 or over (if two parents, 75% each)	Fully	82.5
Lump-sum death benefit	Spouse with whom deceased worker had been living, or spouse or child eligible immediately for monthly survivor benefits	Fully or Currently	\$255
<b>Disability</b>			
Worker	Disabled worker under 65	Fully and Disability	100
Spouse	Disabled worker's wife, 62 or over	Fully	50
	Disabled worker's wife, caring for worker's child under 16, or disabled child, if disabled before 22	Fully	50
	Divorced wife (in some cases) of disabled worker if 62 or over and at least 10 years of marriage	Fully	50*
Child	Disabled worker's dependent, unmarried child under age 18,** or regardless of age if disabled before 22	Fully	50

\*Reduction applies if benefit claimed before normal retirement age.

\*\*Or if attending elementary or secondary school at age 18.

Source: Robert J. Myers, *Social Security*, 4th ed. (Philadelphia: Pension Research Council, Wharton School, University of Pennsylvania, 1993), p. 66, Table 2.3, and Yung-Ping Chen, *Social Security in a Changing Society*, 2nd ed. (Bryn Mawr, PA: McCahan Foundation, 1980), p. 37, Table 1.

who remarried after age 60 can receive only the larger of the widow(er)'s benefit or the spousal benefit.

In addition, there is a Windfall Elimination Provision (WEP). This affects persons who receive both a pension based on noncovered work after 1956 and Social Security benefits. Pensions subject to the WEP include U.S. Civil Service Retirement System annuities, retirement benefits based on foreign earnings, and state and local government employee pensions based on noncovered earnings.

For WEP to apply, eligibility for the noncovered-work pension and the Social Security benefits must begin after December 31, 1985. WEP reduces the Social Security PIA for these persons and affects all their benefits except survivors. (The worker's pension from the job not covered by Social Security is not affected.) The WEP reduction remains in effect until entitlement to the noncovered pension ends, the wage earner dies or the wage earner earns a total of 30 years of substantial Social Security earnings. The WEP reduction amount never exceeds one-half of the noncovered pension.

A WEP PIA is generally calculated with an initial AIME replacement rate of 40 percent (up to the first bend point) instead of 90 percent as with the regular PIA. If a worker has more than 20 years of substantial covered earnings, the WEP PIA starts rising. With the 21st year of such earnings, the first bend point percentage is increased by five percentage points. This rate of increase applies for each additional year of such earnings, through the 30th year, at which point the WEP no longer applies. Thus after 23 years of substantial covered earnings, the first bend point percentage would be 55 percent. After 30 years of substantial covered earnings, the first bend point percentage would be the normal PIA rate of 90 percent.

### ***Taxation of Benefits: The Stealth Means Test***

Benefits were long exempt from the income tax, the Treasury having ruled that for tax purposes, benefits were gratuities, *i.e.*, gifts, and therefore not taxable. The 1983 Amendments introduced taxation of benefits. Specifically, they mandated including in taxable income up to one-half of the OASDI benefits for individuals whose "combined income," the sum of adjusted gross income plus nontaxable interest income plus one-half of Social Security benefits, exceeded \$25,000 (if the beneficiary was single) or \$32,000 (if married and filing a joint return).

In 1984, only about 10 percent of retired households had incomes high

enough to be affected by this change. But since the taxation thresholds are not indexed for inflation, as nominal incomes rise over time, an ever-increasing proportion of elderly beneficiaries will have their incomes pushed into the taxable range, until eventually most retirees will pay this additional tax. Assuming a “low” inflation rate of 3 percent, in 30 years \$25,000 will be worth what \$10,000 is today. This necessarily means that taxation of benefits amounts to means testing by stealth.

In 1993 Congress increased the maximum share of OASDI benefits subject to taxation, from 50 percent to 85 percent, for beneficiaries whose “combined income” exceeded \$34,000 if they were single or \$44,000 if they were married and filing a joint tax return. The additional revenue thus raised was directed to Medicare’s Hospital Insurance (HI). Below these income levels, 50 percent of benefits remain subject to taxation.

By splitting “combined income” into intervals and taxing a larger share of benefits as “combined income” rises, the 1993 change increases the progressivity of benefit taxation and thereby, of course, increases its resemblance to a means test.

### ***Financial Structure: A Ponzi Scheme***

Social Security’s employee payroll taxes (FICA) and self-employment taxes are collected by the United States Internal Revenue Service, and go into the Treasury’s general revenue pool, commingled with revenue from all other sources (Federal income tax, excise taxes, etc.). Social Security’s two Treasury accounts, the Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund, are then credited with an equivalent value of special unmarketable Treasury debt issued for this specific purpose. The Treasury pays Social Security benefits and debits these “trust funds” for amounts of these unmarketable Treasuries equal to the benefit outlays. Any remaining balance (*i.e.*, any leftover stock of Treasuries) at the end of the fiscal year is Social Security’s “surplus,” the actual revenues having already been spent on general government operations.

Social Security is thus a “pay-as-you-go” system, in which current revenues fund current costs. Your tax payments do not pay for your own benefits. Indeed, they cannot, since Social Security has no means of forward funding its future obligations. It cannot use your tax money to accumulate holdings of private stocks, bonds and real estate that have market prices and therefore market value, and that can be realized for cash to pay your

benefits. The Treasuries in the trust fund earn interest at the average market yield on outstanding marketable federal securities not due to mature for at least four years from the date of determination, but interest payments are made in the form of additional quantities of unmarketable federal debt. Your tax payments, therefore, are used to finance transfer payments to current beneficiaries.

A pay-as-you-go system of transfer payments from the young to the old operates exactly like a Ponzi scheme. In 1919 one Charles Ponzi devised a bogus investment fund promising fantastically high returns. The first investors did indeed do well, but Ponzi had made no investments; he paid off the initial investors with money collected from the second round of investors, who in turn were paid off with money collected from the next round of investors, and so on. Eventually the pool of investors dried up, and the Ponzi investment scheme ended when Ponzi was arrested with \$3 million in assets and \$7 million in liabilities.

Not only is Social Security a Ponzi scheme on a national scale, it was so from the beginning. According to one estimate, a 65-year-old man retiring in 1940 had paid in, through combined employee and employer contributions, enough money to fund a yearly retirement annuity of \$6.59 (based on life expectancies at that time). But the average Social Security benefit paid out in 1940 to a 65 year old male was \$270.60. Thus 97.7 percent of that benefit—\$264.01—was a transfer payment from younger workers rather than a return of his actual contribution. Later generations of retirees paid more into Social Security, of course, but also received back far more than they paid, thanks to taxes extracted from younger generations, who correspond to the later rounds of investors in Ponzi's scheme, making their "investments" (tax payments) while young, then receiving their "returns" (benefits) from the next generation's "investments" (taxes). As long as the pool of new entrants and their incomes keeps growing faster than the payout obligations, benefits can be paid. Social Security's ability to keep paying benefits depends not on how well past contributions were invested (for they were not) but on the willingness and ability of the current workforce to pay taxes. This ability in turn depends on broad economic and demographic factors that determine the demand for benefits and the supply of taxes.

### ***Social Security and Budget Accounting***

Until the late 1960s the operations of the Social Security trust fund were

not part of the general budget of the U.S. government. Beginning in fiscal year 1969, however, Congress adopted a “unified budget” which combined all federal revenues and outlays, including Social Security. This was done partly to give a more accurate measure of the total magnitude and economic role of federal taxing and spending.

After the 1983 Amendments to the Social Security Act, OASDI began running substantial surpluses. These surpluses reduced the amount the federal government had to borrow from the public to cover its revenue shortfalls. They also made the unified budget deficits of the 1980s and early 1990s much smaller than those years’ large, chronic on-budget deficits.

Incidentally, the 1983 amendments were not designed to generate OASDI surpluses. The surpluses resulted partly from more taxes, but also from errant projections involving economic growth, interest rates, wage levels and price inflation, as well as projections on the future trends of labor force participation, births, deaths and immigration. It turned out that economic growth was faster, price inflation lower and demographic trends more favorable than were expected in 1983.

The line “Combined surplus/deficit” in Table 5 isolates the difference the OASDI surpluses made in Federal budget accounting. The unified surplus/deficit figure is slightly different because miscellaneous other items such as the Postal Service are also counted as “off-budget” items, but it is clear by inspection that OASDI’s surpluses usually played a major role in making the budget deficit seem smaller than it really was. Likewise, in the late 1990s, when the government began running relatively small on-budget surpluses,

**Table 5: On-Budget, OASDI, and Total Federal Receipts, Outlays, and Surpluses/Deficits (-), Selected Fiscal Years, 1990-2010**  
(billions of dollars)

<i>Item</i>	<i>1990</i>	<i>1995</i>	<i>2000</i>	<i>2005</i>	<i>2010 est.</i>
On-budget receipts	\$750.40	\$1,000.90	\$1,554.90	\$1,576.40	\$2,201.40
On-budget outlays	1,028.10	1,227.20	1,458.50	2,070.00	2,540.50
On-budget surplus/deficit (-)	-277.6	-226.4	86.4	-493.6	-339.1
OASDI receipts	281.7	351.1	480.6	577.5	753.3
OASDI outlays	245	330.4	396.2	506.8	658.3
OASDI surplus/deficit (-)	36.7	20.7	84.4	70.7	95
Combined surplus/deficit (-)	-240.9	-205.7	170.8	-422.9	-244.1
Unified budget receipts	1,032.10	1,351.90	2,025.50	2,153.90	2,954.70
Unified budget outlays	1,253.10	1,515.90	1,789.20	2,472.20	3,049.10
Unified surplus/deficit (-)	-221	-164	236.2	-318.3	-94.4

Source: *Historical Tables, Budget of the U.S. Govt., FY 2008*

the Social Security surplus made the unified budget surplus much larger (see table entries for fiscal 2000). With on-budget deficits returning, the OASDI surplus is reverting to its role of unified budget deficit mitigation.

### *Actuarial Analysis*

By law, the Board of Trustees of the OASDI Trust Funds is required to report to Congress every year on the current and projected future financial status of the Trust Funds. The Board of Trustees' *Annual Report*, [www.ssa.gov/OACT/TR/TR07/index.html](http://www.ssa.gov/OACT/TR/TR07/index.html), issued in March or April, contains detailed actuarial projections of Social Security's financial status over the short range, defined as the next 10 years, and the long range, defined as the next 75 years. The latter period is chosen because it approximates the maximum remaining lifetime of current Social Security participants, including the youngest current taxpayers. Thus the 2007 report contained an actuarial analysis for the periods 2007-2016 (short range) and 2007-2081 (long range).

The actuarial analysis is based on the payroll tax rates and benefit formulas mandated by current law, and on assumptions by Social Security's actuaries regarding the future magnitudes of demographic and economic variables including the fertility rate (number of lifetime births per woman), mortality (death rates), life expectancy, the annual level of immigration, productivity (ratio of real Gross Domestic Product (GDP) to hours worked by all workers), the growth rate of real GDP, the unemployment rate, the inflation rate, average earnings, the growth of real wages and the interest rate earned by the Treasury debt in the OASDI Trust Fund. The assumptions and methods used by the actuaries are reexamined every year in light of recent experience and new information about future conditions, and changed if revision is deemed appropriate.

Because projections of these factors and their interrelationships are necessarily uncertain, Social Security's actuaries use three different sets of plausible assumptions, designated as "intermediate" or "most likely," "low cost" or "optimistic" and "high cost" or "pessimistic." The intermediate assumptions reflect the actuaries' best estimate of the outlook for the population and the economy. The estimates are not meant as precise predictions, but rather as indicators of a reasonable range for Social Security's likely future incomes and costs under a range of plausible assumptions. The actuaries anticipate that the actual future will be somewhere within

the range bounded by the low-cost and high-cost analyses.

Using these analyses, the actuaries evaluate OASDI's future financial condition for both the short range (the next ten years) and the long range (the next 75 years). For the short range, the actuaries measure the OASDI Trust Fund's adequacy by comparing assets at the beginning of each year to that year's projected expenditures under the intermediate assumptions. If the trust fund ratio for each year is at least 100—i.e., if assets at the beginning of each year at least equal that year's projected outgo—the fund is deemed adequate to cover short-run contingencies. According to the trustees, both the OASI and DI trust funds are adequately financed over the next 10 years (i.e., through 2016) under the intermediate assumptions.

For the long range, the main measure of OASDI's financial status for the period as a whole is the “long-term actuarial balance,” the difference between (1) the summarized cost rate and (2) the summarized income rate. The summarized cost rate is the ratio of the sum of the present value of cost over the period plus the present value of the targeted ending trust fund level (100 percent of annual cost at the period's end), to the present value of taxable payroll for the period, expressed as a percentage of taxable payroll. The summarized income rate is the ratio of the sum of the trust fund balance at the beginning of the period plus the present value of scheduled tax income over the period, to the present value of taxable payroll for the period, expressed as a percentage of taxable payroll. If the long-term actuarial balance is zero or positive, then by definition the trust fund ratio at the period's end will be 100 percent or greater, and the program's financing is deemed adequate for the period.

The criterion for the long range is “long-range close actuarial balance.” Using the intermediate assumptions, summarized cost and income rates are calculated for each of 66 valuation periods, the first being the next 10 years, with each succeeding period becoming longer by one year, culminating in the full 75 years. OASDI is said to be in long-term close actuarial balance if for each of the 66 periods the actual balance is either zero or, if negative, by no more than a specified percentage of the valuation period's cost rate, rising from zero for the 10-year period to minus five percent for the 75-year period. For the past several years, the Board of Trustees has warned Congress that Social Security is not in long-term close actuarial balance.

The future income, cost, trust fund asset level, etc., projected by Social Security's actuaries are just that—projections. Although discussions of

Social Security’s outlook almost always treat these figures as exact, they are best thought of as ballpark figures or approximations. They may and probably will be wrong, they change every year and they are only as good as the assumptions underlying them. Nonetheless, a rough indicator is better than none.

### *Social Security’s Size and Importance*

Initially modest in size, Social Security has become one of the largest features of our national landscape, thanks to repeated expansions and liberalizations and to the great growth in America’s population.

In calendar 1950 (13 years after Social Security taxation started, 10 years after benefit payment began), 48.2 million American workers were in occupations covered by Social Security, and 2.9 million Americans were receiving benefits. By calendar 2000, 153.5 million workers were paying OASDI taxes, and 45.2 million Americans were collecting benefits—38.6 million collecting old-age and survivors benefits, and 6.6 million getting disability benefits. At the end of calendar 2002, 46 million persons were receiving benefits: 39 million getting old-age and survivors benefits (32 million retired workers and their dependents, seven million survivors), and seven million getting disability benefits. An estimated 153 million workers

**Table 6: Resource Extraction Through Social Security Taxes 1950-2010**  
(dollar amounts in billions)

<i>Fiscal year</i>	<i>OASDI tax revenue</i>	<i>Federal income tax revenue</i>	<i>Total federal tax revenue</i>	<i>Gross Domestic Product (GDP)</i>	<i>OASDI tax revenue as %</i>		
					<i>of federal income tax revenue</i>	<i>of total federal tax revenue</i>	<i>of GDP</i>
1950	\$2.1	\$15.8	\$39.4	\$273.4	13.3	5.3	0.8
1955	5.1	28.7	65.5	395.2	17.8	7.8	1.3
1960	10.6	40.7	92.5	518.9	26.0	11.5	2.0
1965	16.7	48.8	116.8	687.9	34.2	14.3	2.4
1970	33.5	90.4	192.8	1,013.2	37.1	17.4	3.3
1975	62.5	122.4	279.1	1,559.8	51.1	22.4	4.0
1980	113.2	244.1	517.1	2,732.1	46.4	21.9	4.1
1985	186.2	334.5	734.1	4,136.6	55.7	25.4	4.5
1990	281.7	466.9	1,032.0	5,735.6	60.3	27.3	4.9
1995	351.1	590.2	1,351.8	7,324.0	59.5	26.0	4.8
2000	480.6	1,004.5	2,025.2	9,718.8	47.8	23.7	4.9
2005	577.5	927.0	2,153.9	12,265.8	62.2	26.8	4.7
2010*	753.3	1,428.3	2,954.7	16,112.4	52.7	25.4	4.6

\* Estimate. Source: *Historical Tables, Budget of the U.S. Govt., FY 2008*

paid payroll taxes.

As Table 6 shows, Social Security’s tax has become a mighty machine for extracting resources from the private sector. In the 50 years from 1950 to 2000, Social Security taxes have almost quintupled as a share of Gross Domestic Product (GDP) and as a share of total federal tax revenues. By 2010, more than one out of every four federal tax dollars was raised by the Social Security tax, and the amount of revenue raised by the Social Security tax was more than half as much as the amount extracted by the Federal income tax.

The imperative driving this soaring taxation, of course, is the growth of the benefit outlays that the taxes must finance. This has its roots in the repeated expansion of the program until eventually virtually the entire labor force participated; the liberalization in 1950 that reduced eligibility requirements to bring additional millions of elderly Americans under Social Security with minimal quarters of coverage; repeated increases in benefits; and the increase of America’s population.

Table 7 depicts the explosion of benefits spending since 1950, in absolute terms and both as a share of total federal spending and as a share of GDP. For every fiscal year beginning with 1993, Social Security has been the largest single item in the federal budget. In fiscal 2006 Social Security accounted for 21 percent of federal outlays, versus 20 percent for national

Table 7: **Social Security Outlays, Federal Spending, and GDP, 1950-2010**  
(dollar amounts in billions)

<i>Fiscal year</i>	<i>OASDI outlays</i>	<i>Total federal outlays</i>	<i>GDP</i>	<i>OASDI outlays as % of total outlays of GDP</i>	
1950	\$0.8	\$42.6	\$273.0	1.88	0.29
1955	4.4	68.4	394.6	6.43	1.12
1960	11.6	92.2	517.9	12.58	2.24
1965	17.5	118.2	687.1	14.81	2.55
1970	30.3	195.7	1,012.2	15.48	2.99
1975	64.7	332.3	1,560.7	19.47	4.15
1980	118.6	590.9	2,726.7	20.07	4.35
1985	191	946.4	4,141.5	20.18	4.61
1990	249.7	1,253.10	5,735.4	19.93	4.35
1995	335.9	1,515.90	7,325.8	22.16	4.59
2000	409.5	1,789.20	9,709.8	22.89	4.22
2005	523.3	2,472.20	12,265.8	21.17	4.27
2010*	682.6	3,049.10	16,112.4	22.39	4.24

\* Estimate. Source: *Historical Tables, Budget of the U.S. Govt., FY 2008*

defense and nine percent for net interest on the national debt.

As the baby boom generation retires, Social Security's costs will of course be driven much higher still. Chapter III addresses this matter at greater length.





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