LONG-RANGE FISCAL POLICY BRIEF

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Social Security Reform: The Use of Private Securities and the Need for Economic Growth

Various proposals have called for using private securities to reform Social Security. Some would have the federal government buy them for the Social Security trust funds; others would have workers invest in them by diverting, to personal accounts, some of the federal taxes that they pay. As significant as those changes may seem, their economic effects are largely uncertain. By itself, using government resources to buy stocks and bonds, without other spending and tax changes, would not automatically lead to an increase in the nation's pool of investment resources—there is no free lunch. With one hand, the government would buy or make resources available to acquire securities; with the other, it would continue to borrow; and what the resulting impact on national savings and investment would be is unclear. Much would depend on reactions—in personal savings and fiscal policies—that are not predictable.

It is the economy's capacity to grow, however, that offers the greatest security to the nation's aging population. Under current projections, the number of people age 65 or older will nearly double from 2000 to 2030, growing by 34 million. In contrast, the number of workers will rise by only 24 million. Whereas there were 4.4 workers for every aged person in 1970, there will be only 2.6 in 2030. To a large extent, the goods and services that society will consume in 2030 will have to be produced then, and with the demographic shift, greater demands will be imposed on the nation's workers. Consequently, expanding the economy to create a larger base of production is critical.

Much of the current debate about Social Security has centered on how to establish claims on future resources for the system. The use of private versus public securities, the creation of personal accounts, the scheduling of future tax increases, and reliance on future borrowing by government—while different both in form and potential effects—are all means of financing that prescribe how resources would be drawn from the economy, not how to produce them. Having the economy expand requires measures that, among other things, induce people to consume less so that more money is available for investment. Increasing aggregate national savings by running budget surpluses and using them to pay down the federal debt could help, but how those surpluses were created, along with other factors, would be important. Constraining government expenditures that add to consumption, adopting policies that advance productive technology and investment in human capital, eliminating regulations that inhibit productivity, and adopting tax measures that reward personal savings and work effort are the types of policies that are likely to have the greatest chance of spurring growth.

The Underlying Debate About Reforming Social Security

The Social Security system is a collective one. Each worker's Social Security taxes are not put aside to pay his or her eventual benefits; instead, they are used to finance the system in general, largely for current retirees. As with other federal levies, Social Security tax receipts go into the U.S. Treasury, and any portion not needed to pay current beneficiaries is used to finance the government's other functions or to reduce its debt. The Social Security trust funds are given credit for the

excess, which generally is in the form of Treasury securities, and although the law refers to those securities as investments, they are not assets for the government. They are internal obligations of one government account to another, and as such, they are bookkeeping entries. When cash is needed to pay benefits, it comes from the Treasury. The Social Security Board of Trustees projects that the system's tax revenues will begin lagging behind its expenditures in 2017. At that point, even though the Social Security trust funds will have credited balances for 24 more years, the program will be relying on payments from the Treasury—funds that will come from higher taxes, lower spending elsewhere, or more borrowing. Said another way, the budget and economic consequences in 2017 are not altered by the existence of the Social Security trust funds.

Proponents of the current system say that its collective design protects society as much as the individual against poverty. They argue that despite the many other means by which people prepare for retirement, the system is a primary source of support for a large proportion of the aged and disabled. They agree that workers should be able to make their own investment decisions but feel that those choices should be made with personal savings and private pensions, not through the Social Security system. However, because stocks and nongovernmental bonds historically have rendered higher returns than Treasury securities, some advocates of the system favor their use for Social Security. They would have a board or quasi-governmental entity invest the program's trust funds in private securities, aiming to use the financial markets to benefit Social Security recipients as a group.

Others who seek a new system believe that a better approach would allow people to invest their own money for their own use and earn their retirement income on the basis of their own decisions. They maintain that if people want to take risks, they should be able to; if they want to be cautious, they should have that choice, too. Such reformers would allow workers to divert some of the federal taxes that they pay to personal accounts and require either that they transfer some of the assets they accumulate to the Social Security trust funds or that they have their traditional Social Security benefits offset in some manner. Each worker would thereby build a supplementary source of retirement income, perhaps making up for future constraints on benefits that may be needed to keep from overburdening future generations of workers.

The Amount the Economy Can Produce in the Future Is What Matters Most

Philosophical issues aside, the post-World War II baby-boom generation's retirement—however it is financed—will result in fewer workers for every retiree. The significance of the population's aging is illustrated by the decline in the number of workers per aged person that is projected to occur over the next three decades. In 1970, there were 4.4 workers for every aged person, and over the subsequent decade, the growth in the number of workers was four times that of the aged population (*see Table 1*). In contrast, the Social Security trustees project that from 2020 to 2030, roughly the reverse will occur: the increase in the aged population will triple that in the working population, and by 2030, there will be only 2.6 workers for every aged person.

Table 1.

The Looming Change in the Ratio of Workers to Retirees

	Millions of People				
	Workers	Population Age 65+	Increase in Workers During Previous Decade	Increase in Population Age 65+ During Previous Decade	Ratio of Workers to Population Age 65+
1970	93.1	20.9	20.6	3.7	4.4
1980	113.6	26.1	20.6	5.2	4.3
1990	133.7	32.0	20.0	5.9	4.2
2000	153.7	35.5	20.0	3.5	4.3
2010	165.4	39.5	11.8	4.0	4.2
2020	172.8	53.2	7.4	13.7	3.3
2030	178.1	69.4	5.3	16.3	2.6
2050	189.8	78.3	5.4	3.1	2.4

Source: Social Security Administration, *The 2002 Annual Report of the Board of Trustees of the Old-Age and Survivors and Disability Insurance Trust Funds* (March 26, 2002).

That shift will impose greater demands on the economy. To a large extent, what the population will need three decades from now will have to be produced then. Food, clothing, medical care, and many other needed services cannot be stored in advance. In essence, society's future consumption by both workers and retirees will be met largely through the future production of goods and services.

Projections of the Social Security program's costs reflect those demands: as a share of gross domestic product, its expenditures could rise from 4.5 percent today to 6.6 percent in 2030—an increase of almost 50 percent. Moreover, that projected rise is not temporary. The demographic shift emerging with the baby boomers' retirement is not merely a bulge in the proportion of elderly to nonelderly but a large step in a long-term shift to an older society caused by increasing longevity and persistently low birth rates. And because other sources of retirement benefits—pensions and health programs, for example—will also be affected, projections of Social Security spending portray a common pattern but only a fraction of the total costs of retirees for society.

It has been suggested that if birth rates remain low, the rising costs of the aged might be offset by the lower costs of raising fewer children—the implication being that the overall dependency on workers may not be all that troublesome. Projections of the segments of the population that are not of working age (people under 20 and people 65 or older), considered together as a percentage of working-age adults, are not higher than when the baby boomers were in their youth.

But studies have shown that governmental income support and health care spending for the aged (by all levels of government) substantially exceed governmental spending associated with educating and providing services to children.[1] Moreover, the level of dependency on working-age adults is not projected to fall when the baby boomers die, as it did when they emerged from childhood; and a tax burden that rises with the costs of programs for the elderly could carry the additional problem of impairing productivity-enhancing investments and incentives for people to work and, therefore, produce more.

The Means of Financing Matters Less

The motivations for considering the use of private securities in reforming Social Security are predictably diverse, given that so much of the debate is about what the role of government should be. However, to the extent that the rationale is to increase the well-being of future generations in their retirement, expectations may be too high. The draw on society 30 years from now to meet the needs of a large retired population will not be any less simply because private securities could be liquidated then.

1. For additional discussion, see Congressional Budget Office, *Long-Term Budgetary Pressures and Policy Options* (May 1998).

At first glance, that conclusion may not seem intuitive: why wouldn't retirees' asset sales make them better off, or "richer"? The answer is that the value of the assets, physical or financial, will depend upon the size of the economy. The value of a share of the average corporation will increase only if the economy grows. Put another way, the assets that retirees sell will be bought largely by their children, but the funds can come only from the children's savings and only at a price that they can afford to pay. The assets accumulated by future retirees (current workers) will boost their well-being in retirement only to the extent that those assets help the economy grow.

Earmarking government resources to acquire private securities—whether for government trust funds or personal accounts—may accomplish little. If it causes people to reduce their private savings because they feel more secure about receiving Social Security benefits, aggregate national savings could fall. In other words, the effect on national savings ultimately depends on personal savings behavior, much of which cannot be predicted. The effect on national savings also depends on how government fiscal policies would be affected. Investing government funds in private securities will not necessarily increase economic growth. If the money to invest came from having a higher level of government borrowing, new money would not have been added to the nation's pool of investment resources. While economists tend to have strong opinions about what the outcome would be, their analyses are largely influenced by the subsequent fiscal policies that they assume the government would follow—which are political and not economic predictions.

Future strains on the economy will partly depend on older workers' retirement patterns. People are expected to live longer, but as yet there is little evidence that they will work longer. In the early 1960s, the average age of retirement on Social Security fell quickly; after that it declined gradually and, more recently, leveled off. According to the Social Security trustees' projections, in the future workers are expected to choose to retire at close to the same ages that they do today. It has been speculated that future shortages of labor resulting from the relative decline in the working population may cause many would-be retirees to remain in the workforce. To the extent that occurs, pressure on all sources of retirement income, public and private, could be lessened. The total payout of benefits from those systems might not be lower, but the higher ratio of workers to retirees could mean a more economically productive society more capable of meeting its needs.

Achieving a long-range balance of Social Security's receipts and its expenditures is not nearly as important for ensuring retirement security as is the need for the economy to expand. The larger the future economy, the easier it will be to meet the nation's higher consumption demands. Enlarging the economy will require measures that, among other things, induce people to consume less so that there is more money going into investments. Running budget surpluses could increase national savings by making more dollars available for investment, but how those surpluses were created, along with other factors, would be important. Tax increases that impede business investment, personal savings, and work effort may impair productivity. Conversely, constraining government expenditures that add to consumption; adopting policies that advance productive technology and investment in human capital; eliminating regulations that inhibit productivity; and adopting tax measures that encourage business investment, personal savings, and work effort are the types of policies that are likely to have the greatest chance of spurring growth.

Conclusion

Much of the recent Social Security debate has revolved around the question of how to establish claims on future resources. The use of private versus public securities, the creation of personal accounts, the scheduling of future tax increases, and reliance on future borrowing by government are all means of financing that prescribe how resources would be drawn from the economy to meet retirement claims. They are not options that will predictably build the resources to meet those claims, and some could be harmful.

It may be important to decide for the coming decades how best to divide the roles of Social Security and private means in paying for retirement. However, it would be a mistake to assume that higher retirement costs in the future could somehow be met simply by building up the Social Security trust funds with public or private securities or altering the mix of methods, public versus private, by which future retirement claims are established. In the end, those options are simply financing tools. They may have different distributional impacts among members of society (affecting who pays, who receives, and how much), but by themselves they will not answer the question of how to produce more. Increasing aggregate national savings (as opposed to trust fund balances); pursuing policies that increase productivity; and encouraging people to work longer are paramount. No matter how much nominal wealth can be traded or cashed in to produce given levels of retirement income, it is the amount of goods and services that can be furnished that will determine society's economic well-being.

Related CBO Publications: *Evaluating and Accounting for Federal Investment in Corporate Stocks and Other Private Securities* (January 2003); *The Impact of Social Security and Medicare on the Federal Budget*, Long-Range Fiscal Policy Brief No. 6 (November 14, 2002); *Social Security and the Federal Budget: The Necessity of Maintaining a Comprehensive Long-Range Perspective*, Long-Range Fiscal Policy Brief No. 3 (August 1, 2002); and *Social Security: A Primer* (September 2001).

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