Social Security – What is it and what should it be?

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Social Security benefits are very important to, and generally well perceived by, the United States population. However, not all the press is favorable. The trust fund out of which benefits are paid is expected to be depleted by around 2035, and at that point incoming tax revenues may only support about three-quarters of promised benefits. Before jumping headlong into solutions, it makes sense to step back and ask what the program really is and should be.

US national pension plan

In many respects Social Security has become our national pension plan. The expansion of benefits and increases in tax withholding over the years have elevated its status considerably above its humble beginnings. Once envisioned as a safety net to prevent widespread poverty among the elderly, it now represents the only pension plan providing guaranteed lifetime monthly income serving the majority of US workers.

Of course, payroll taxes are not insignificant, requiring 6.2% of pay contributions from both employee and employer, for a total of 12.4% of pay. Social Security benefits were enhanced in the mid-1980s. Since then, tax laws, accounting rules, and government regulations have discouraged many employers from sponsoring defined benefit retirement plans. Defined contribution or savings plans with individual account balances, and no guarantee for the size or duration of retirement income, have become the norm with private sector employers. Many workers do not save aggressively in those plans, and employer contributions or matches range widely from none to quite generous.

Going forward, many people retiring in the US will not have significant sources of guaranteed lifetime income other than Social Security. So, should Social Security be our national pension plan? It may be too late to even ask that question, at least for the next 20 years of retirees who have been working and planning under the current regime. Employees and employers have been pouring more than 12% of pay into the system, crowding out many other potential solutions. Radical changes would have to be phased in slowly, or the original mission of preventing widespread poverty among the elderly could fail.

Ponzi scheme

Some people, especially certain politicians, accuse Social Security of being a Ponzi scheme that will inevitably go bust. However, a Ponzi scheme is an investment fraud that uses money from current investors to pay fake returns to previous investors, thereby creating the appearance of a valid investment without having an actual economic basis for ongoing returns. Social Security started by collecting taxes from workers and distributing those funds to impoverished retirees. It was never claimed to be an investment that set aside workers' funds in accounts for their later use. The first wave of "returns", i.e. payouts to retirees, was provided to people who never put money into the system.

While current projections do predict the trust fund will be depleted in less than 15 years, that only occurs under certain assumptions including that all current benefit and tax provisions are left unchanged. Note that even on that basis payroll taxes would be projected to support about three-fourths of the current benefit structure over the following 40 years once the trust fund is gone. Current Social Security Trustees projections indicate the imbalance, if addressed now, would only be about 3.3% of workers' wages[i].

These facts imply a more accurate characterization of Social Security – from day one through the present – as transfer payments from current workers to current retirees. The program is only authorized to use payroll taxes to provide benefits, with temporary excesses accumulated in its trust fund. Relatively plausible changes to the system's benefit and tax parameters could bring the program back into long-term alignment. In the mid-1980s the current structure[ii] was expected to remain solvent for 75 years; it looks like we might only get 50. It is still quite an achievement to have engineered a benefit/tax structure that remains viable for so long – what other federal program has been relevant and solvent for 50 years?

Slandering Social Security as a Ponzi scheme is inappropriate, and precludes evolutionary thinking that could make the program strong, relevant and solvent for the next 50 years.

Social contract

While transfer payments might be a technically correct description of the mechanics of Social Security, the more substantial truth is that it is a social contract across multiple dimensions. It is both a commitment by current workers to help support the retirement of their parents' and grandparents' generations, and an ongoing transfer from wealthier socioeconomic classes to the less well off.

We all know that parents and grandparents dedicate tremendous resources to raising their children and grandchildren. Social Security can be viewed as a small payback to the generations on whose shoulders current workers stand. Each generation must also commit to raising the following generations of productive workers, not just parents individually raising children, but the entire society providing educational and employment opportunities as well as economic prosperity. That includes career development, advancements, and at the appropriate time, retirement-age employees liberating the top-tier jobs by retiring to collect Social Security benefits.

The simple fact of the payroll tax commitment is also an intergenerational social contract. Prior generations have contributed money into Social Security, knowing it was being spent on other people, because that's what civilizations do. A civilization looks out for its citizens because an individual is vulnerable to endless adversities. Continuity of commitments is a key part of what binds a culture together.

The program today has evolved considerably since the original concept of relieving poverty among the elderly, but the benefit structure still retains that progressive bias. Social Security's formulas are complex, but in essence the program replaces a portion of a worker's preretirement pay. The lowest levels of pay are 90% replaced, the next level 32% replaced, the following level 15% replaced, and earnings above the taxable wage base (currently about $143,000) are not replaced. The tax rate paid while working is a flat percent of pay, but income replacement is skewed heavily towards retirees at lower pay levels who would be most likely to face poverty without Social Security.

This means the program is not just an intergenerational social contract, but also has an income redistribution effect, from higher-paid socioeconomic classes to the less wealthy. Above the taxable wage base there is symmetry; the tax rate is zero and so is retirement income replacement. But at levels below the wage base some earnings are only 15% replaced “to pay for” lower levels of income being 90% replaced. This is a different aspect of the social contract, perhaps no less important than the intergenerational commitment.

To be a valid social contract Social Security must be balanced in many ways. Payroll taxes must be reasonable, to not crush the dreams and aspirations of current workers. However, the rates also need to be sufficient to meet program objectives consistent with the social contract. Sometimes circumstances dictate changes must be made, but corrective actions cannot be too abrupt, or the contract is broken instead of reformed. The current tax and benefit structure of Social Security has been largely the same since the mid-1980s, demonstrating the consistency and reliability befitting a social contract.

The program is at a crossroads, requiring nontrivial adjustments to remain solvent. Central to engineering a “fix” is deciding whether Social Security should in substance remain the kind of social contract it has been, to what extent the social contract needs to be fundamentally changed, or perhaps that it should not be a social contract but rather is a policy experiment whose time has passed.

Unsustainable

Another label sometimes brandished in Social Security discussions is unsustainable. In a literal sense, under the current benefit structure and tax rates, that assertion is perhaps factual. Estimates are that by about 2035 tax inflows will only cover a portion – perhaps around three quarters – of promised benefits[i]. But considered more broadly as a program, Social Security will almost certainly be adjusted back into balance somehow. How the Social Security Administration is required to ration payments to retirees when incoming tax revenue covers less than full benefits would only represent one dire – and unlikely – approach to restoring equilibrium.

As a social contract there are an infinite number of adjustments that could bring Social Security back into balance. There are choices to be made, some of them difficult. However, they are choices that can and will be made by our elected leaders. It is well within the reach of the nation to sustain Social Security, if we decide to.

Where do we go from here?

As asserted at the outset, the first step is not arguing about specific potential fixes. The starting point is to recognize what Social Security is, and then decide what we – as a nation – want it to be. The notes above depict the system as a de facto national pension plan for many current workers who lack other defined benefit retirement options. It is also a pension plan to which employees and employers have committed quite significant contributions. Social Security is not a Ponzi scheme. It is at a crossroads if the program is to be sustainable as the significant social contract it has been for decades.

Any discussion of potential fixes can be dragged quickly into the mire of partisan political warfare, and at the heart of that strife is the fundamental question of what we want Social Security to be for current workers and future generations. If you are in the camp that believes Social Security should be significantly reduced or phased out as a failed policy experiment, the author respects your opinion and recommends you continue reading at your peril. The notes from here on mostly assume that Social Security should be maintained as a significant social contract, but one that is sustainable. A small counterpoint section at the end discusses potential wind-down.

The ideas below for adjusting Social Security back into balance are qualitative, and in no particular order:

- Both critics and supporters of Social Security have pointed out that average life expectancy for a 65-year-old has increased substantially over the years. More years of retirement means higher costs for providing benefits, which puts pressure on funding the system. It may be rational, perhaps even desirable from a fairness perspective, to increase the full benefit retirement age from 67. Intergenerational equity can promote the strength of a social contract.
- At the same time average life span has increased, the increases have not been uniform across the US population. Those of higher socioeconomic status have often benefited more than the lower economic brackets. Early commencement of benefits, down to age 62, may be a necessity rather than a choice for workers in industries with harsh physical demands, or for people who are laid off at later ages when reemployment is more difficult. Both issues could be partially addressed by updating the factors by which Social Security benefits are reduced for early commencement to a more generous basis. The program's current reductions are significant and could over-penalize retirees, relative to income needs at lower pay levels and relative to actual cost impacts for the higher income brackets.
- A similar situation exists for deferring Social Security benefits to after full benefit age, up to age 70. These increases are probably more generous than necessary, especially considering that wealthier workers are more likely to be able to utilize this feature, while lower income workers often cannot choose to defer retirement from physically demanding jobs.
- Changes noted above are not likely to move the needle enough to bring the Social Security system back into balance. If benefit costs are higher than contributions and funding, one must either reduce benefits or increase contributions. The possible 25% gap in costs mentioned previously is not a small discrepancy.
- Increasing contributions can be achieved with a larger, more productive US workforce. Better education and training can promote a higher-wage population that would automatically contribute more dollars in payroll taxes. However, the funds associated with providing better education and training opportunities would have to come from somewhere. Recent experience indicates tuition increases well above inflation can no longer be supported solely though mushrooming student debt. The burden would likely fall to taxpayers, at the local, state, or federal level. No one welcomes higher taxes.
- A larger US workforce, and hence payroll tax base, could also be promoted through targeted immigration policy that prioritizes those with significant current earnings or potential. This could be even more politically charged than raising taxes. However, one of the largest adversities facing Social Security is the significant decline in the ratio of current workers – paying taxes into the system – to beneficiaries of the system – retirees and dependents receiving monthly benefits. Trying to directly motivate an increase in US birth rates has dubious moral implications, in addition to the likelihood it would fail, whereas importing additional workers has a long history in the building of our nation. Most of these workers would pay into the system for decades before claiming benefits, hopefully beyond the baby boomer retirement bubble.
- Increasing the tax rates or taxable wage base could also increase funds coming into the system. Raising the rate from 12.4% would increase the burden on current workers, especially those at lower income levels who already spend every penny they make supporting themselves and their families. Increasing the taxable wage base might be more palatable, since we are talking about pay above $143,000. But in today's political environment that could still be viewed by some as an assault on the middle class. Introducing a payroll tax on earnings above a higher threshold – such as $400,000 – might garner broader political support, though it would also generate less

tax revenue. Moreover, to maintain the social contract it would be reasonable to include those taxed earnings in the individual's taxable wage base and the subsequent (15%) income replacement scheme of Social Security. Then the system is potentially providing a tier of "benefits" – overpriced though they may be – to only the wealthiest taxpayers.

- From the other direction, Social Security benefits could be reduced to help bring the system back into balance. However, reducing payouts at the lower levels of income – where monthly checks are already perceived as meager and perhaps insufficient – would work against the foundational goal of preventing poverty among the elderly. More likely would be some form of means testing whereby payouts are reduced for individuals with significant sources of retirement income from outside the Social Security system, such as other company or government pensions, retirement savings plans, personal investments, etc. This could be done through a number of vehicles, including increased Medicare premiums and deductibles for wealthy retirees with cost savings put into the Social Security system, benefit reductions applied to monthly benefits for a portion of retirement income above certain thresholds, or a Social Security surtax on high-income retirees reflected as withholding and tax on the "employer half" of monthly benefits.
- Benefit payments could also be adjusted for unemployment levels. Again, the lower income portions of monthly amounts – attributable to the 90% replacement scheme – would probably be exempted. As an example, the 32% and 15% replacement percentages could be become 37%-U% and 20%-U% where U% is an appropriate unemployment rate, reflected each year based on the most recent data like cost of living adjustments. This would "share the pain" of a struggling economy and partially scale system benefit payouts to available payroll tax revenue.
- Then there are off-the-wall possibilities, like a national lottery that disperses half of ticket sales to lottery winners and puts the other half into the Social Security system. Or legalizing marijuana at the federal level, charging a national sales tax on the product, and putting those receipts into Social Security. It is likely that the creativity of such proposals would exceed their ability to garner consensus.

Any realistic redesign of Social Security that would bring it back into long term balance probably must adopt more than one or two of these ideas. We need an all-of-the-above approach (except maybe the lottery or legalizing marijuana) to bridge the significant projected gap between incoming tax revenues and outgoing benefit payouts. Some of the puzzle pieces, such as education funding and immigration policy, are not even part of the tax/benefit structure of Social Security; they fall within the realm of broader US policy. The real question is not whether bringing Social Security back into balance could be done within the economic means of our nation, but whether there is any political force, or any person, with enough political capital and dynamism to bring everything and everyone together under the same tent.

Counterpoint

Some have argued that if we do nothing the system will self-destruct under its own weight by 2035. Incoming taxes will only cover about three-fourths of promised benefits, and bureaucrats with the appropriate authority will ration the payouts so that Social Security continues to live within its budget. Ironically, that might lead to a sustainable long-term social contract: workers will be taxed at the stated rates, and the funds so collected will be disbursed to beneficiaries based on the original benefit promises and some systematic process for rationing. This could be a rough ride, as evolving demographics and economic cycles jar the system.

A more calculated wind down would amend the system rules so that younger workers today know well in advance that Social Security will not be as significant a benefit in the future. Perhaps workers' wages would continue to be taxed at current rates, but the benefits base – i.e. the amount of pay considered for income replacement at retirement – would decline each year until the system starts to show a surplus. Then the tax rates could be phased out over time, as system payouts diminish. This might better protect near-term retirees while penalizing those workers who have the most time to adjust to the broken social contract. However, the near-term cash crunch would still have to be addressed through some combination of adjustments as discussed above.

There are also proposals to migrate the Social Security system from its defined benefit roots to a defined contribution design where individual participants have separate account balances to call their own. It is hard to see how a system that will only collect enough in taxes to pay three-quarters of promised benefits would somehow also set aside dollars for individual wage-earners' accounts. That would also convert the social contract into an individual matter, without a safety net to prevent poverty among the elderly.

In any event, the author believes our nation will move in the other direction to support the promise of Social Security within an affordable and sustainable social contract.

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[i] See *Highlights*, THE 2020 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND FEDERAL DISABILITY INSURANCE TRUST FUNDS (https://www.ssa.gov/OACT/TR/2020/index.html)

[ii] https://www.ssa.gov/history/1983amend.html