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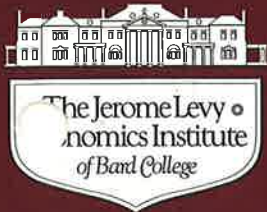
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## How Can We Provide for the Baby Boomers in Their Old Age?

*Dimitri B. Papadimitriou and L. Randall Wray*

***Accumulation of financial assets in the Social Security Trust Fund does not, by itself, ensure that retiring baby boomers will obtain a sufficient share of society's output in the year 2020; only use of the tax system in 2020—not accumulated assets or budget surpluses—can guarantee that result. And, even if it were true that budget surpluses could increase productive capacity, such an outcome is best left to general fiscal policy rather than to the Social Security program. There is, therefore, no theoretical justification for running large OASDI surpluses.***

The current belief behind the operation of OASDI is that accumulating large financial balances in the Trust Fund can help ease the burden on future workers created by demographic changes and slow projected growth of taxable real wages.<sup>1</sup> The purpose of the Trust Fund is thought to be to accumulate financial reserves now, which can be depleted in later years, when Social Security program expenditures exceed the revenues that will be generated from a shrinking tax base. In other words, the annual surpluses will be “saved” over the next 20 years in order to provide for the future consumption of retiring baby boomers. The thinking behind much of the debate over Social Security seems to be based on the belief that if we do not increase *financial saving*, retirees will not get a sufficient distribution of society's output of goods and services in 2020 or 2030 or other years into the future.

However, if sufficient distribution of goods and services is what the debate is really about, almost all of the solutions proposed thus far have at best an uncertain probability of succeeding. This is because most proposals center on increasing the size of the Trust

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Fund—by some combination of reduced benefits and increased tax rates in the near term and by increasing the fund's rate of growth, for example, by "investing" it in the stock market to obtain higher returns than those expected to be earned on its stock of government bonds. It is supposed that a larger Trust Fund will postpone a "day of reckoning" since its interest earnings will supplement payroll tax receipts and assets can be sold when total revenues fall short of expenditures. This is the path recommended by President Clinton in his State of the Union Address when he proposed that just over 60 percent of projected government budget surpluses over the next 15 years be "set aside" for the Trust Fund. The Treasury would use the surpluses to retire outstanding debt currently held by the public, but would then issue an equivalent amount of debt (that is, 62 percent of the total budget surplus each year) to be held in the Trust Fund. However, unless accumulation of the Trust Fund actually enhances society's ability to produce goods and services in the year 2020, the output to be distributed will be exactly the same whether the Trust Fund is larger or smaller. In this case, the only economic justification for a larger Trust Fund is the belief that it will increase the distribution going to the retiring baby boomers.

We believe there is no way to guarantee that accumulation of the Trust Fund will shift the distribution of goods and services toward future retirees, and it is not clear that a larger Trust Fund will result in a more desirable distribution. Is there a better and more direct way to ensure that the distribution will be shifted toward retiring baby boomers? Yes—through use of the tax system in the year 2020 or 2030 or whenever receipts fall short of expenditures. In this note we will argue that amending general budget policy would be a more equitable means of directly accomplishing the distributional goal than would amending OASDI alone.

In the year 2020, if it is decided that the elderly should get a larger share of goods and service, payroll taxes can be increased (reducing workers' disposable income) and benefit payments to the elderly can be increased. If the desired goal is to affect distribution of goods and services in the year 2020, it is far more direct and preferable to raise payroll taxes in the year 2020 than to raise them today in an attempt to accumulate financial assets to be sold in the year 2020 on the hope that this

might indirectly affect the future distribution of goods and services.

Moreover, even if nonmarketable Treasury debt is held by the Trust Fund, to convert those securities into cash would require the Treasury to either issue new debt or generate tax revenue in excess of what will be required for other government spending in order to make the cash payment to the Fund without increasing general budget

deficits. This is exactly what would be required even if the Trust Fund had no "financial holdings." In other words, the burden of providing real goods and services to retirees in 2020, 2030, or 2075 will be borne by workers in those years regardless of the tax imposed today.

If the level of goods and services to be produced in the future cannot be increased by actions taken today, then the burden that will be borne by tomorrow's workers cannot be reduced by anything we do today. This argument hinges on the assumption that accumulation of a Trust Fund does not directly affect the quantity of goods and services that will be produced in, say, 2020. Such an assumption might appear to be severe, but most conventional theory concludes that the long-run growth path of the economy is not easily changed. Because accumulation of a Trust Fund is not likely to have a substantial impact on long-run growth, accumulation cannot assure the desired future distribution of resources and will distort current and future market prices. If this is true, payroll taxes should be *reduced* now and then increased later so that Social Security program

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revenues and cost would be more closely aligned. The logical conclusion derived from conventional theory, then, is for the program to be run on a pay-as-you-go basis.

### Can We Enhance Our Future Ability to Produce?

Most proponents of reform probably believe that actions taken today *can* affect the quantity of goods and services that will be available in the year 2020 to distribute among all groups in society. By focusing on the issue of whether growth can be affected, it becomes clear that debates about whether returns in the stock market can beat the returns on government bonds become meaningless. The question is what can we do today to stimulate production in the year 2020. How we go about answering that question depends on our view of the nature of the constraints on economic growth.

The main justification for building up the Trust Fund today is the belief that doing so will increase national saving and thereby stimulate investment. Such an argument is based on the supposition that our economy is "supply constrained," that is, that inadequate private sector saving has kept investment too low. Among the problems with the argument that OASDI ought to run a surplus in order to add to national saving is that it is based on the assumption that the rest of the federal budget (that is, excluding social security) does not go into a compensating deficit. Further, even if it is true that a government surplus can be used to add to national saving and encourage investment, it is not at all clear that this should be done through the OASDI program.

OASDI is not a broad-based program; the taxable OASDI base (the portion of national income that can be taxed to resolve any Social Security shortfall) is far less than half of national income. If government surpluses are to be used to stimulate growth, a general fiscal policy—specifically, the entire federal tax system—would be a more equitable means of generating general budget surpluses to stimulate growth. If such a plan works, the benefits of faster growth would be shared across society, including the OASDI program. Even a small increase in the growth rate of GDP would bring OASDI into financial balance, but the benefits of growth would be spread throughout society. Any costs (such as higher taxes today) should therefore be shared by all of society rather than imposed only on payrolls.

Another justification for generating financial balances in the Trust Fund is that the balances could be used to increase investment directly, for example, by purchasing private equities. Many objections have been raised to such a plan, and we do not intend to repeat these. Again, the question remains as to whether macroeconomic stimulus should be attempted via OASDI. If it is true that direct investment in the stock market can stimulate growth, a more equitable approach would be to do so via the general budget. By extrapolation, policies to increase human capital, to encourage resource mobility, or to finance research and development would be more equitably accomplished through the use of general government revenues than through the use of OASDI revenues. In conclusion, even if it is true that our economy is supply constrained, and even if it is true that government surpluses can reduce such constraints by adding to national saving, this in no way implies that it should be the responsibility of OASDI to generate the surpluses.

In a demand-constrained system any type of spending can raise demand, stimulate output, and raise economic growth, which, in turn, will encourage investment and, thus, raise potential output. Attempts to encourage investment via "incentives" alone may not work in a demand-constrained system because such investment might lead only to excess capacity; it is better to increase other, non-investment spending, which then creates private incentive to invest. Government spending, even if it is deficit financed, will raise demand in this case and thus stimulate investment. On the other hand, a government surplus would actually hinder demand (by taxing more than it spends) and reduce growth.

If our system is demand constrained, accumulating a balance in the Trust Fund would depress growth unless the balance were offset by a deficit on the rest of the government's budget. A pay-as-you-go Social Security system would be preferable to an "advance funded" system for any demand-constrained economy. One could even argue that OASDI deficits in the future would be good precisely because they would stimulate demand. However, for the reasons we stated above, it would be better to leave such aggregate demand stimulation to the overall government rather than to a particular government program.

Is our system demand constrained or supply constrained? We believe that, on balance, the evidence shows our economy is usually demand constrained. We expect that in coming years demand constraints will be even worse than they have been since 1973. As evidence, we point to chronic downsizing of firms, falling commodity prices, stagnant intermediate goods prices, high

unemployment rates in most of the world, and unused capacity throughout the world. The burgeoning Asian crisis, now spreading to Latin America and threatening Europe and the United States, is in part due to excess capacity and inadequate world demand. We see little reason to fear, at least in the near future, that a constraint will arise from insufficient capacity.

Finally, in our judgment it makes little difference if our economy is demand constrained or supply constrained because a pay-as-you-go system is preferred in either case. The search for a solution to the problems faced by the Social Security system should focus not on how to amend OASDI but on how best to achieve faster long-term economic growth. Achieving such growth is better left to the purview of fiscal and monetary policy, not the OASDI system. The objection might be that Congress and the president do not have the political will to undertake such measures, but it is unjustified to "reform" Social Security in order to do what our elected representatives should, but will not, do.

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### Recommendations

We see no compelling argument that changes made today to OASDI could ameliorate any problems that might be encountered long into the future. It is probable that tax rates will have to be increased in the future—perhaps even before 2020. However, the increases will be relatively small. After 2030, perhaps 2 percent more of GDP will have to be devoted to the OASDI beneficiaries than is now devoted. While not insignificant, this is surely feasible without causing an undue burden on future workers. Thus, we are encouraged to make the following recommendations.

1. OASDI should gradually be returned to a pay-as-you-go system. We find no reason to suppose that accumulating large balances in the Trust Fund is a proper way to provide for future retirees. Thus, payroll tax rates should be reduced over the next few years and then increased as required in the future.
2. A discussion should begin over the proper tax base to be used to generate revenue for OASDI. Given demographic changes, which will reduce the working population relative to OASDI beneficiaries, a broader base will be preferred. This is particularly important given that covered

payroll is expected to fall significantly relative to GDP. Discussion should include the possible elimination of the contribution base, or at least of adjustments to this base, to ensure that a constant percent of payroll falls below the base. Inclusion of fringe benefits in the taxable base might also be pursued.

3. The Trust Fund should be capped at no more than 100 percent of expenditures, an amount generally thought sufficient to see the program through back-to-back recessions. We would actually prefer to cap the Trust Fund at a much lower figure, since a reserve of 8 to 9 percent is sufficient to meet liquidity needs; general budget funding could be provided in severe recessions as necessary.
4. General fiscal policy should be biased to encourage faster growth, greater employment, and higher labor force participation (especially of women). This would not only benefit OASDI but it would also provide wide benefits to society. However, we repeat that this should be undertaken as part of general fiscal policy, rather than as OASDI policy.
5. We believe other major changes to OASDI, such as partial or complete privatization, reduction of benefits, or extension of retirement age, have no place in the "reform" of Social Security.

### Note

1. Old-Age and Survivors Insurance and Disability Insurance (OASDI).

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- "Transcript: Clinton's State of the Union Speech, January 19, 1999." CNN Interactive, January 20, 1999. <http://cnn.com/ALLPOLITICS/stories/1999/01/19/sotu.transcript/>.

### Related Publications

For additional Levy Institute research on this subject, see:

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