



Declining Adequacy of Social Security Retirement Benefits

by Bruce D. Schobel

Measures of *Adequacy*?

I must make a general observation first: I prefer to consider “adequacy” relative to minimum living standards. Of course, other definitions have validity too, but most combine other concepts with the narrower notion of adequacy.

A common measure of retirement-income “adequacy” is the replacement rate: retirement income relative to preretirement earnings, sometimes adjusted in some way to reflect inflation. The philosophy underlying the use of these rates is that, as a matter of “fairness,” retired people should be able to maintain their preretirement standard of living. They need to receive a determinable percentage of preretirement earnings to accomplish this goal. These lifestyle-maintaining replacement rates, which vary by income level for a variety of well-known reasons such as varying marginal tax rates and declining work-related expenses, are not too difficult to compute, and many analysts have done this.

Validity of Projections

We can determine fairly easily the replacement rates of yesterday’s and today’s retirees, but determining the corresponding figures for tomorrow’s retirees depends to some extent on the projection model used. Of course, computer models can be only as good as the assumptions on which they are based, if they are even that good. In this situation, the assumptions should be regarded with considerable skepticism, simply because they extend several decades into the future.

Analyses of *short-range* economic forecasts by even the most highly respected economists demonstrate the

great uncertainty that exists in this field. Economists, and everybody else, for that matter, have demonstrated little ability to forecast even a few years ahead, let alone decades. Even so, some well-known economic models attempt to forecast the situation 30 or 40 years into the future. The Social Security Administration tops them all, attempting the perhaps impossible task of projecting economic and demographic variables for the next 75 years.

Such very long-range projections can be put into perspective in the following way: Consider an economist, or actuary, sitting in his office in 1966 and trying to predict what the U.S. economy would be like 30 years hence, in 1996. How close to reality would he have been? How about another expert in 1956 trying to look ahead 40 years? Then make the enormous leap to an economist in the year 1921, at the start of the Roaring Twenties, trying to forecast 75 years down the road to the present time. Obviously, none of these people—no matter how brilliant—would have had a chance of coming even close to what actually has occurred. Because today’s economists are probably not much better at predicting the far-distant future than their predecessors were, we need to take all of these projections with at least a few grains of salt. The use of computers should not give us much more confidence in the results.

Social Security’s Contribution to Retirement Income

The magnitudes of the most likely future sources of retirement income are quite difficult to project. We have no way of accurately estimating future investment income, for example, because we cannot project with

any real confidence how much people will save during their working years or what future interest rates will be. An exception to this general rule, however, is Social Security. (By this term, I refer to the Old-Age, Survivors, and Disability Insurance, or OASDI, program.)

Social Security, regarded for almost 60 years now as the “floor of protection” for working Americans, provides the foundation on which other retirement programs are built. Social Security’s contribution to the typical retiree’s replacement rate, which is thus a matter of considerable interest, increased for the first several decades of the program’s existence, but it has been declining slightly since about 1979. It can be expected to decline much more in the future, for three reasons:

1. Changes already enacted into law will reduce the adequacy of Social Security benefits, especially for workers born after 1959.
2. Changes in family work patterns will reduce or eliminate certain “free” benefits that have historically been provided to married couples.
3. Future financial problems will require additional reductions in Social Security benefits.

Changes Already Enacted into Law

The present-law benefit formula (enacted in 1977) produces absolutely stable and predictable replacement rates under any economic conditions. Stated briefly, a worker with average earnings in every year (about \$26,000 in 1996) who retires at his or her “normal retirement age” (NRA) will receive benefits at retirement that are about 41% of the earnings in the year before retirement. Similarly, an otherwise identical worker with maximum covered earnings (\$62,700 in 1996) will, in the long run, receive benefits at retirement that are about 25% of the last year’s earnings.

These figures, and the continuum of replacement rates for earnings between average and maximum and at earnings levels below the average, were essentially fixed by the Social Security Amendments of 1977 (Public Law 95-216). Because Social Security’s financial picture is pretty good for about the next 16 years, according to the 1996 Annual Report of its board of trustees, we can probably anticipate that the benefit provisions of the law—the most difficult provisions to change—will remain about the same as they are today for at least that long. Thus, Social Security’s contribution to future retirement income can be predicted with greater confidence than that of probably any other

source. Still, Social Security has some surprises in store for the unwary retiree.

The stable replacement rates described above are for workers retiring at NRA. The NRA was age 65 when Social Security began, and it remains there for workers born before 1938, who become eligible for Social Security early retirement benefits before the year 2000. For workers born in 1938 and later, however, the NRA rises, under provisions enacted into law as part of the Social Security Amendments of 1983 (Public Law 98-21). Eventually, for workers born after 1959, the NRA reaches 67. Thus, to get the same Social Security replacement rate that a worker gets today at age 65, retirees becoming eligible for benefits in 2022 and later will need to wait two years, until age 67.

The fact that increasing the NRA is a benefit reduction may be obvious already, but it becomes much more obvious when considered in light of the large percentage of beneficiaries who claim early-retirement benefits before reaching NRA. Nearly three-fourths of the nondisabled eligible population claims Social Security retirement benefits at age 62. At exact age 62 the early-retirement reduction is 20% today; therefore, these early retirees receive 80%, or slightly more, of the benefit that they could receive if they waited until age 65 (this ignores the effects of additional earnings, which are relatively small in most cases). Their replacement rates are therefore lower. For example, the hypothetical average earner described above could receive 41% of his or her last year’s earnings from Social Security at NRA; at age 62 today, the replacement rate would be only 33%, that is, 80% of 41%.

In the future, early-retirement benefits will continue to be available at age 62, but because the number of years of early retirement will increase (from three to five), the early-retirement reduction factor increases also. Starting in 2022, workers who retire at exact age 62 will receive just 70% of the benefit that would be payable at NRA, instead of 80% today. This represents a 12-1/2% relative reduction in benefit amount. The replacement rate for a hypothetical average earner who retires at NRA would be just 29% in 2022, instead of 33% today. Clearly, unless retirement behavior changes, Social Security will contribute less toward the adequacy of retirement income in the future than it does today.

The question of whether retirement behavior will change is worth considering. Americans have been retiring earlier and earlier for many decades, and nobody has been able to show that this trend will ever reverse. Of course, Americans have also been living longer, and

we might anticipate that some of this extra longevity will be reflected in longer working lives, rather than going entirely to longer periods of leisure. On the other hand, we could speculate that greater affluence, which the government projects to occur, will allow the trend toward earlier retirement to continue indefinitely or maybe just level off sometime.

The retirement-age increase is not the only change already enacted into law that will tend to make Social Security benefits less adequate in the future. Another is the increasing proportion of benefits that will be subject to federal income taxation, under provisions first effective in 1984 and expanded in 1994. Today, only about 20% of Social Security beneficiaries are required to include any of their benefits in taxable income, because only those with fairly substantial retirement incomes—\$25,000 annually for single individuals and \$32,000 annually for married couples filing joint tax returns—are subject to this tax. The thresholds are frozen, however: that is, not indexed to inflation like most other tax parameters; therefore, the proportion of beneficiaries affected grows each year as more and more people have incomes exceeding the thresholds. Because the tax functions like a benefit reduction—and, in fact, has been described as a benefit reduction for certain purposes, like determining the relative amounts of tax increases versus benefit reductions in the 1983 package of changes—the adequacy of benefits will be reduced. The precise extent of this reduction cannot be determined accurately, because federal income tax rates change so often.

Changes in Family Work Patterns

In one-earner families, which were typical decades ago and are predominant in today's retired population, the nonworking spouse, usually the wife, receives a benefit roughly equal to half of the retired-worker spouse's benefit, depending on their respective ages. In other words, if a hypothetical average earner who retires at NRA has a nonworking spouse the same age, then their combined replacement rate is not 41 percent, but 62 percent.

Today, most married women work long enough in paid employment to receive Social Security benefits in their own right, based on their own earnings. When these two-earner couples retire, they will ordinarily not be eligible for any such spousal supplements, because each worker's own retired-worker benefit will offset any potential spouse's benefit, reducing it to zero in

most cases. The point at which reduction to zero occurs depends on many factors, but it almost always happens when one spouse has average indexed monthly earnings of one-third of the other spouse's average indexed monthly earnings. Without supplemental spousal benefits, the combined replacement rate for the retired couple, both with average earnings in every year, would be just 41 percent at NRA, a huge reduction from 62 percent today.

These reductions in future Social Security benefits resulting from changes in family work patterns will continue after one spouse dies. Under Social Security law, the surviving spouse receives a benefit essentially equal to the benefit that had been received by the higher-earning spouse. If that spouse dies, the other spouse gets a widow(er)'s benefit equal to what the deceased spouse had been receiving; if the lower-earning spouse dies, the higher earner simply continues to get whatever benefit had been paid before the other spouse's death, and the deceased spouse's benefit ends. For the traditional one-earner retired couple that we see today, this means that the benefit reduction at the first spouse's death is about 33%. For a hypothetical average earner with a nonworking spouse the same age, the replacement rate while both are alive is 62%; after the first spouse dies, the replacement rate drops to 41%.

When today's two-earner working couples retire, they will have less survivor protection, because of the absence of spousal supplements. When the hypothetical married average earners retire at NRA, each will receive a retired-worker benefit replacing about 41% of that person's last year's earnings. The overall replacement rate for the retired couple is therefore 41% of fair combined preretirement income. When one spouse dies, that person's benefit will end, reducing the overall replacement rate to 21% of combined preretirement income, as compared to 41% today. Again, this is a huge reduction. Finally, the percentage of single-person families has been increasing. When these people retire, they obviously can receive no spousal supplements and consequently will have lower than average replacement rates.

Future Financial Problems and Their Effects

The Social Security program will begin to have problems meeting its financial obligations in the year 2012, just 16 years from now. At first, the problem will

be manageable. By 2020, however, it will exceed \$200 billion. In 2030, the shortfall will be \$700 billion; in 2035, it will be just under \$1 trillion. The program will have to be changed sometime during this period, and the changes will inevitably include benefit reductions.

All Social Security benefits and administrative costs are paid from the program's "trust funds." When the trust funds have more income than outgo, the excess is retained by the Treasury and used to meet the government's non-Social Security expenses. In return for using Social Security's extra revenue, the Treasury issues to the trust funds special U.S. government bonds. When the trust funds have less income than outgo, the difference must come from bond redemptions. In practice, this means that the Treasury cancels some of the bonds and provides cash, which comes from other sources and is then used to meet the revenue shortfall.

Since 1983, Social Security's trust funds have grown rapidly, because revenue has greatly exceeded outgo. The revenue that was not needed immediately to meet the program's obligations was automatically used to purchase special-issue government bonds, which totaled \$496 billion at the end of 1995. For several years now, most policymakers have justified higher than necessary Social Security tax rates on the grounds that large trust funds need to be accumulated to meet future needs.

Nobody disputes that the situation will inevitably reverse when the baby-boom generation reaches retirement age and begins receiving benefits. When that happens, the large pool of government bonds that will have been accumulated as trust fund assets on the Treasury's books over the three to four decades since 1983 will be drawn down. According to the trustees' intermediate estimates, this drawing down of fund assets will begin around 2019 and continue for about 10 years. During this time, the trust fund assets will shrink from \$3 trillion (2-1/2 years' outgo initially) to zero. The program will continue to operate during this period only by redeeming bonds, at an average rate of \$300 billion per year. In 2029, the last of the accumulated bonds will be redeemed, and the program will become unable to pay its benefits on time without changes in the law.

How will the Treasury redeem such huge amounts of bonds? Its choices are limited:

1. *Sell bonds to the public.* The Treasury always has the option of selling bonds one place to make redemptions in another place. Whether the public has sufficient appetite to buy additional bonds at an

average rate of \$300 billion per year, even in the inflationary dollars of 2019–29, remains to be seen.

2. *Raise taxes.* Policymakers can raise taxes to provide the Treasury with the necessary money. More directly, they could raise Social Security taxes, reducing the need for bond redemptions.
3. *Print money.* The Treasury is in the unique position of being able to print money. It could redeem Social Security's bonds by increasing the money supply, but not without increasing inflation. Because Social Security benefit increases are tied to changes in the Consumer Price Index (CPI), inflation would result in even higher benefit costs and the need to redeem bonds more rapidly, not to mention causing other deleterious economic effects. No administration could prefer this solution.

Because bond redemptions on such a massive scale would be so difficult—perhaps even impossible—we have to ask whether they would happen at all. Policymakers could avoid questions involving how to redeem the accumulated bonds and whether the amounts are really available by simply leaving the trust funds' bonds untouched. They could claim that a large trust fund needs to be maintained forever, as a contingency fund for the future, and they could accomplish this by enacting into law a package of revenue increases and benefit reductions, as was done in 1983, and matching Social Security's income and outgo as soon as the imbalance would otherwise occur, in 2012.

Without changing the fundamental structure of Social Security, the following "big-ticket" items would almost certainly be included in such a package:

1. *Increases in FICA tax rates.* Virtually every major piece of Social Security legislation since 1950 has included increases in payroll-tax rates. Tax increases are easy to explain, and workers pay the additional amounts largely through withholding from wages and salaries. (Note that increased taxation of Social Security benefits will probably not be a possible source of revenue, because the increases enacted into law in 1993 will result in nearly all the benefits being subject to tax in the future.)
2. *Reductions in COLAs.* Social Security's cost-of-living adjustments (COLAs) were delayed six months by the 1983 legislation, but the annual increases were maintained at 100% of the change in the CPI. In 1986, Congress enacted a smaller COLA—so-called "diet COLA"—for federal employees covered by the new Federal Employees' Retirement System (FERS). This new retirement system will eventually cover all members of Congress, who may

be inclined to apply their COLA procedure to the general population under Social Security. Moreover, many economists have come to agree that the current measure of inflation, the CPI, tends to overstate inflation, for a variety of reasons. Certain technical corrections have already been made, but several causes of overstatement cannot be corrected technically. These could be used as justification for a proposal such as reducing benefit increases to “CPI minus 1%.”

3. *Increases in normal retirement age.* The 1983 legislation raised the NRA—the age at which unreduced retirement benefits are first available—from the historical age 65. Congress has demonstrated that it knows how to reduce benefits through changing the NRA; it could easily do so again. Age 67 is no more special than was age 65 before 1983.

Privatization as a Solution

Some advocate solving the program’s future financing problems in less traditional ways. Recently, the 1994–95 Advisory Council on Social Security developed three proposals that would restore the program’s long-term financial solvency without dramatic benefit reductions. The three proposals rely to a great extent on two types of “privatization”:

1. *Invest the trust funds in equities.* Currently, the assets of the Social Security trust funds are invested in U.S. government bonds, as required by law. Those bonds pay market rates of interest—about 2–3 percentage points above the rate of inflation—but many analysts believe that much greater returns could be achieved in the private equity markets—about 7 percentage points above the rate of inflation. With these higher returns, Social Security’s trust funds would grow larger and decline more slowly, with investment income meeting more of the program’s needs. Investment procedures could be changed to allow such private-sector investment, with appropriate safeguards against market manipulation, through the use of index funds, for example. Nevertheless, the vast sums involved could result in unintended effects on the equity markets and would result in government ownership of private-sector assets to an extent not seen before in the United States. Nevertheless, this proposal is at the heart of one of the Advisory Council’s plans.
2. *Partial or complete privatization.* The other two plans go further, taking some funds out of the government’s hands and allowing individuals to

direct their own private-sector investments. One proposal would impose a new 1.6% contribution requirement on individuals, while leaving the current tax-rate schedule in place. The other would make much more dramatic changes, directing individuals to contribute 5% of pay to private-sector investment accounts and reducing the government program to providing a flat minimum benefit.

Privatization would address the concerns of some that Social Security has become a very bad investment for many workers. Initially, Social Security was a remarkably good investment, because the earliest beneficiaries received full benefits after having paid taxes for just a few years, and at a very low rate. Subsequent beneficiaries paid much higher taxes for similar benefits relative to previous earnings. This is typical of any defined-benefit pension plan that intends to pay adequate benefits from the outset. Since 1979, however, taxes have continued to rise, while benefits have actually declined and become subject to income taxation for those beneficiaries with substantial incomes from other sources. Privatization, in contrast, would allow each worker to receive whatever he or she could earn in an individual account, eliminating much of the redistribution across income and generational lines that takes place under the current program.

The model for many privatization ideas in the United States is Chile and, to a lesser extent, other countries, such as Argentina, that made similar changes after Chile did so. Chile privatized its social security system in 1981, although certain government guarantees were left in place in the event of very adverse experience. To date, the experience has been very favorable. Moving to privatization had substantial transitional costs in Chile and elsewhere. These costs would present a major obstacle to Social Security privatization in the United States.

Private-Sector Products Would Facilitate Privatization

Partial or complete privatization, as described above, would entail individuals depositing contributions into retirement savings accounts of some type. Some observers have questioned whether such a system could be put into place because of administrative concerns. In fact, the necessary products already exist in today’s financial marketplace.

Americans have been able to contribute to so-called 401(k) plans for nearly two decades. Individual

Retirement Accounts have been available for even longer, although not so universally. The amounts already contributed to such plans exceed what would be added through Social Security privatization. These plans handle large and small amounts with equal efficiency; administrative costs are ordinarily spread proportionally.

Thousands of mutual funds operate today in the United States. Many of these have minimum-deposit requirements, but these are not typically so high that they would prevent any full-time workers from enrolling. Even low-paid workers would accumulate enough private-sector contributions after a few years to buy into virtually any mutual fund. Although administrative costs are typically higher, as a percentage, for smaller accounts, the absolute levels are not usually so high as to reduce the overall rate of return below what would be available under Social Security.

Insurance companies sell deferred annuities that are ideal for accumulating retirement savings. Moreover, the accumulated amounts can be annuitized at retirement, protecting the recipient against the risk of outliving his or her assets. Annuity contracts have been sold for more than a century, and the existing market is huge and diverse. Insurance companies also sell ordinary and flexible-premium life insurance contracts, which can be used to accumulate cash values, although that is not their primary purpose.

Conclusion

Already scheduled changes in law and the way that it functions in the context of changing family circumstances will cause Social Security benefits to decline substantially from today's levels, relative to previous earnings. Thus, everything else being equal, retirement income can be expected to be less adequate in the future than it is today. The additional reductions in Social Security benefits that will be required because of the program's anticipated financial difficulties further accentuate the need for workers to save more if they want to maintain their preretirement standard of living. The necessary amounts cannot be saved during the last few working years; they must be accumulated over much longer periods. The necessary savings can be accumulated within the framework of a government program under privatization or achieved entirely on a voluntary basis. The financial products needed to facilitate privatization already exist, and the markets for such products are well developed.

In any case, baby boomers and younger workers need to be told that their Social Security benefits will

be substantially less adequate than those of today's retirees, and they need to know now so that they have time to take appropriate actions to have more retirement income available from other sources.

Discussion

by Richard V. Burkhauser

Bruce Schobel is pessimistic about the ability of changes in Social Security rules to increase the labor force participation of workers. He states, for instance, that he has seen no evidence that the trend in early retirement has reversed. However, Table 1 in my paper shows that single-year-of-age labor force participation rates of men aged 62 and over stopped dropping in the mid-1980s and have remained constant or have increased somewhat since then.

In my view an increase in the earliest age of eligibility for Social Security benefits from 62 to 65 would yield a substantial increase in work during those ages. The more important questions are how many people would still not work once the earliest age of retirement was increased and what proportion of these nonworkers would be seriously harmed as a result. Burkhauser, Couch, and Phillips (1996) suggest that these numbers would be smaller than is currently imagined.

Using data from what will be the primary source of information on the cohort of workers who will retire over the next decade—the Health and Retirement Survey—we measure the health and economic well-being of those who first take Social Security retirement or spousal benefits at age 62. Contrary to conventional wisdom, we find the typical early Social Security beneficiary in 1993 and 1994 was about as healthy and wealthy as the typical postponer. Most men who took Social Security benefits at age 62 were healthy (80 percent report having no health problems that limit the type or amount of work they can perform); nearly two in three were receiving an employer pension to go along with Social Security; and the net assets of the median early beneficiary were just over \$160,000, more than the net assets of the median male postponer. Less than 10% of male early Social Security beneficiaries were in poor health and also had Social Security as their only source of pension income. This vulnerable group made up less than 3% of the population of 62-year-old-men in our sample. The statistics for women who took benefits at age 62 are about the same.

It will be necessary to trim Social Security liabilities further to guarantee the fiscal integrity of the Social

Security system when we baby boomers retire. It is our generation who will have to agree to lower our benefits for the sake of our children and grandchildren. Returning the age of first eligibility for Social Security benefits to age 65, where it was before 1961, is better than cutting yearly benefits. It will not dramatically lower the economic well-being of the typical person aged 62, since most men and women that age are neither in poor health nor dependent on Social Security benefits alone for their pension income. Hence, they could, if necessary, continue to work or retire and depend on private pension benefits until age 65.

In 1960, the year before early Social Security benefits were first introduced, 79.4% of men aged 61 and 75.7% of men aged 63 were in the labor force. In 1996, despite improvements in both mortality and morbidity, those numbers fell to 64.8% and 45.3%, respectively (see Table 1 in my paper). The dramatic drop in work between ages 61 and 63 over this period is an artifact of our retirement system. (See Quinn and Burkhauser 1994 for a review of the evidence of the labor supply consequences of our current retirement system.) Raising the earliest age of eligibility would start a chain of events in our retirement system that would push labor force participation dramatically upward at ages 62 through 64, and thus overall productivity and the labor earnings base on which Social Security taxes are collected. It would lower the tax burden on our children by requiring us to work longer, but it would also increase the overall pie from which all distributions are cut.

No cut in Social Security benefits will be painless for our cohort. A small minority of men and women aged 62 are in poor health, and, on average, they live in households with substantially less income and net assets than the healthy majority has. When raising the early retirement age, other policies—for example, lowering the age of eligibility for Supplemental Security Income—should be put in place to provide some alternative source of income for this relatively small minority of vulnerable people. But in a world of difficult choices about the use of tax dollars, it is no longer sensible policy to encourage the vast majority of healthy employed workers to leave their job via the Social Security system at age 62. It is time to return the earliest age of eligibility for Social Security retirement benefits to 65.

REFERENCES

Burkhauser, Richard V., Couch, Kenneth A., and Phillips, John W. 1996. "Who Takes Early Social

Security Benefits: The Economic and Health Characteristics of Early Beneficiaries," *The Gerontologist* 36(6):789–99.

Quinn, Joseph F., and Burkhauser, Richard V. "Retirement and Labor Force Behavior of the Elderly." In *Demography of Aging*, ed. Linda Martin and Samuel Preston pp. 50–101. Washington, D.C.: National Academy of Science, 1994.

Discussion

by Krzysztof M. Ostaszewski

"An economist was asked about the meaning of life. He replied: It depends on the parameter values."—World Wide Web site "Jokes about Economists."

Mr. Schobel has written a greatly needed piece in the current debate about social insurance in the United States. He points out obvious, yet largely ignored, points that are of utmost importance in the said debate:

- Social insurance projections depend on parameter values. In particular, patterns of growth of taxable payroll and benefit outlays are the key to the long-term balance of the system, yet they are highly sensitive to underlying assumptions. Mr. Schobel claims that long-term predictions of parameters are futile.
- Social Security's contribution to Americans' retirement income will decline in the future, regardless of any changes that will be instituted in the system.
- The baby boomers need to be told clearly that the system cannot provide the same rates of return to them as it has to previous generations, so that their patterns of work and savings can adjust early enough to facilitate their retirement.
- The financial industry has developed to the point at which private market financial products needed for retirement can absorb privatization of the Social Security system.

Although I consider Mr. Schobel's analysis to be of great value, and vastly superior in its sophistication to what commonly passes for analysis in political debates on social insurance, I feel compelled to choose to disagree on some issues.

Futility of Long-Term Predictions

The key to understanding the Social Security system and its consequences lies in making it very plain and clear that OASDI is a political institution. "Politics" is used as a dirty word in the modern American political

lexicon. It is not a dirty word, nevertheless. In its classical meaning, it represents ethics as applied to the practice of human relations in large groups. Retirement is possible without politics. It is achieved through purchase of capital assets and accumulation of enough of them to replace working income. Why did politics get involved in retirement? The answer is somewhat obvious, but it can be illuminated by some work of Smith (1995), who discusses the wealth of the American nation, its distribution, and the savings patterns. He finds that a typical household in the United States has very modest wealth holdings, that disparities in wealth are large, and that poorer households save very little. He also finds that inheritances are not important for wealth inequities, whereas income levels, marital status, and health level are significant. His most significant finding is that Social Security completely dominates the wealth for poorer households, and that it is still the largest form of wealth even for an average household. Smith points out that poor households have no incentive to save, because of the structure of social insurance and social assistance programs. There has been a heated debate on the effect of social insurance on savings. Recent research (for example, Hubbard, Skinner, and Zeldes 1995) does point out that savings patterns are negatively affected by social insurance, although in probably less obvious ways than previously suggested. Therein, in our opinion, lies the problem.

Poor and elderly Americans have responded to economic incentives as expressed by the politics of social insurance. The promises of Social Security and Medicare have been that you will be able to retire and afford health care in retirement without having to save much. What is missing in this promise is the caveat that in order for it to work, it must apply to a small portion of lower income population. If it applies to everyone (as it has to a great degree in Social Security and fully to Medicare), it implies that social insurance taxes earn dramatically higher rates of return (as they have; see Myers's and Schobel's calculations) than do assets placed in private markets. This means that consumption pays. This also means that if you are not a beneficiary of an American social insurance program, but can sell your goods and services to consumption-hungry Americans, you will indirectly benefit. Thus, we see great prosperity increases in countries exporting to the United States, and an excessive incentive to save for their populations.

The U.S. cannot generate the productive capacity for its own consumption, but given its consumption, somebody will. With an especially dramatic increase in

consumption by the elderly, a tremendous incentive to provide them with consumed items also develops. Thus, we are seeing a boom in health care industries, services, and other, similar industries serving the elderly in the United States. I do not believe that long-term predictions are impossible. They cannot be exact in their scale and timing, and in this regard I agree with Mr. Schobel. But given the structure of incentives, one can predict responses and results. In the midst of the 1930s, with socialism triumphant in Russia and Germany, Ludwig von Mises predicted a collapse of both the communist and the national socialist regimes. He was ostracized and ridiculed for that prediction. He merely pointed out that a socialist regime must fall because in the absence of markets, government is unable to calculate prices of resources. His long-term prediction was valid, although its precision and dates of fulfillment can be debated. Social insurance nationalizes private markets for capital. It causes government to be unable to calculate prices for capital, that is, what rates of return are needed for various risky projects in the economy in order to create incentives for capital to be saved for them. If social insurance systems are small in relation to the economy, and especially if they are run on a purely pay-as-you-go basis and are providing a minimal level of support, this effect is minimal, and the resulting economic inefficiency can reasonably be traded for social adequacy. But if social insurance systems attempt to deliver substantial portions of income for everyone, they must fail. Economic calculation by individuals is the backbone of the free enterprise system. It cannot be replaced by economic calculation by experts, as von Mises pointed out a half century ago. This claim tends to enrage the experts, but given the evidence of the twentieth century, some humility may be well advised.

One more issue is crucial in long-term predictions. Social insurance creates tremendous political incentives. It enables political agents to promise and increase benefits while hiding the costs of such benefits. Political agents promoting economic calculation may indeed be helpless in that debate, no matter how rational their arguments. They were helpless in Germany and Russia in the early twentieth century and eventually died or left. The largest cost of any economic policy is the long-term growth of the economy that is lost because of such policy. This is hard enough to prove in the court of scholarly debate, and nearly impossible to substantiate in the political debate, where there is no truth-in-advertising requirement. Most individuals will not know how different 2% growth is as compared to 5%

growth. Generally, 2% growth ensures reelection. But 5% growth of a competitor country ensures future immigration of the most industrious and creative people to that competitor, further dampening the long-term prospects of a nation. Indeed, a prolonged period of low growth may be the greatest political trap ever devised. And this is the key long-term prediction for the United States based on the state of its social insurance.

Social Security's Contribution to Retirement Income Will Decline

This is true only in an optimistic scenario. Mr. Schobel provides a list of items that will contribute to this prediction. However, his scenario is based on an assumption that may not happen—that Americans will indeed start saving adequately for their own retirement and accept politically a lower Social Security contribution. There is no evidence of such a development yet. Indeed, the nation and the government appear to be engaged in a game of “chicken.” The nation is not saving for its retirement, hoping that the social insurance system will provide sufficient resources. The government has allowed a long-term actuarial deficit to grow to astronomic proportions, hoping to reduce future benefits or raise needed funds some time in the future when the nation accepts greater responsibility for its retirement. The key question is, Who will blink? From the purely economic standpoint, it would appear that the nation must blink first, because to close the actuarial deficit, the payroll tax would have to be raised now by about 7% (and given negative feedback in tax increases, we firmly believe that an increase of about 10% would be truly needed), a highly unlikely scenario, possibly resulting in a major recession, or worse. The government cannot raise taxes that much. But the government is not a uniform entity, and as of now any politician who suggests cuts in Medicare or Social Security is most likely to become a retired politician. The political incentives of social insurance are far greater than the economic incentives. It simply pays to do nothing in the face of the crisis. And . . . there is no crisis. As Lucille Ball put it, “I cannot be overdrawn; I still have some checks left.” Until the combined social insurance system of Social Security and Medicare experiences a negative cash flow, there is no political crisis. According to the statement of Richard Foster, the chief actuary of the Health Care Financing Administration, at the Bowles Symposium, this will happen

in 1998. If short-term financing can be arranged, there will be no crisis then either.

The only price for these phenomena is the low growth of the national economy. As long as it exceeds 1% annually, there is no political cost, thus no political incentive to change. And with growth like that, it is actually much more likely that the contribution of Social Security to retirees' incomes will increase. To put it succinctly: the nation does not want to blink; Americans firmly refuse to save more on their own. The nation wants money from the government, and the fact that the nation as a whole will become relatively poorer is irrelevant.

The Baby Boomers Need to Be Told the Truth

Yes, they do need to feel their pain. But politicians who say so do not get reelected. Therefore, given the savings rate in the United States, the conclusion is that baby boomers know the truth, but that either they do not want to hear it, they do not believe it, or, my hypothesis, they have serious doubts about the very concept of “truth.” I am personally firmly committed to delivering the unpopular message, but given the political incentives of the system, I think it is naive to assume that the people will respond to the information that quickly. It is much more politically expedient simply to “write some more checks,” and those who do just that are much more likely to succeed politically. We can best tell which message is getting through by watching the national savings rate.

Financial Markets Are Sophisticated Enough to Absorb Needed Savings

I agree in general, but disagree in one particular aspect. Any massive transfer of retirement provision to the private sector will require a major change in the role of government, from provider to regulator. I am not certain if the government is prepared for that. It is simpler and easier to transfer funds than to supervise financial institutions. If we privatize (which is my sincere wish), we must understand that the government will have to police newly emerged private retirement providers controlling massive amounts of the nation's savings. Given that the advisory council is instead proposing for the government to purchase private securities,

I am quite concerned that the regulatory authorities are not prepared for this challenge. The proposal to accumulate massive control of the private sector in the government-run retirement provider shows instead great desire to continue and expand the government's economic, instead of regulatory, role.

REFERENCES

- Hubbard, Glenn, Skinner, Jon, and Zeldes, Steven. 1995. "Precautionary Savings and Social Insurance," *Journal of Political Economy* 103, no. 2:361-99.
- Smith, James P. 1995. "Unequal Wealth and Incentives to Save." RAND Documented Briefing.