SOCIAL SECURITY AND THE FEDERAL BUDGET

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What does Social Security do?

- Retirement benefits
- Survivors benefits
- Disability benefits

How does Social Security work?

- Payroll tax: 12.4% of first $102,000 in wages
  - Split between employer and employee
- Surplus taxes credited to trust fund
- Retirement benefits replace progressive share of pre-retirement earnings
  - Low: 56%; medium: 41%; high: 34%; max: 28%
- Spouse can receive own benefit or benefit equal to 50% of spouse's, whichever is greater

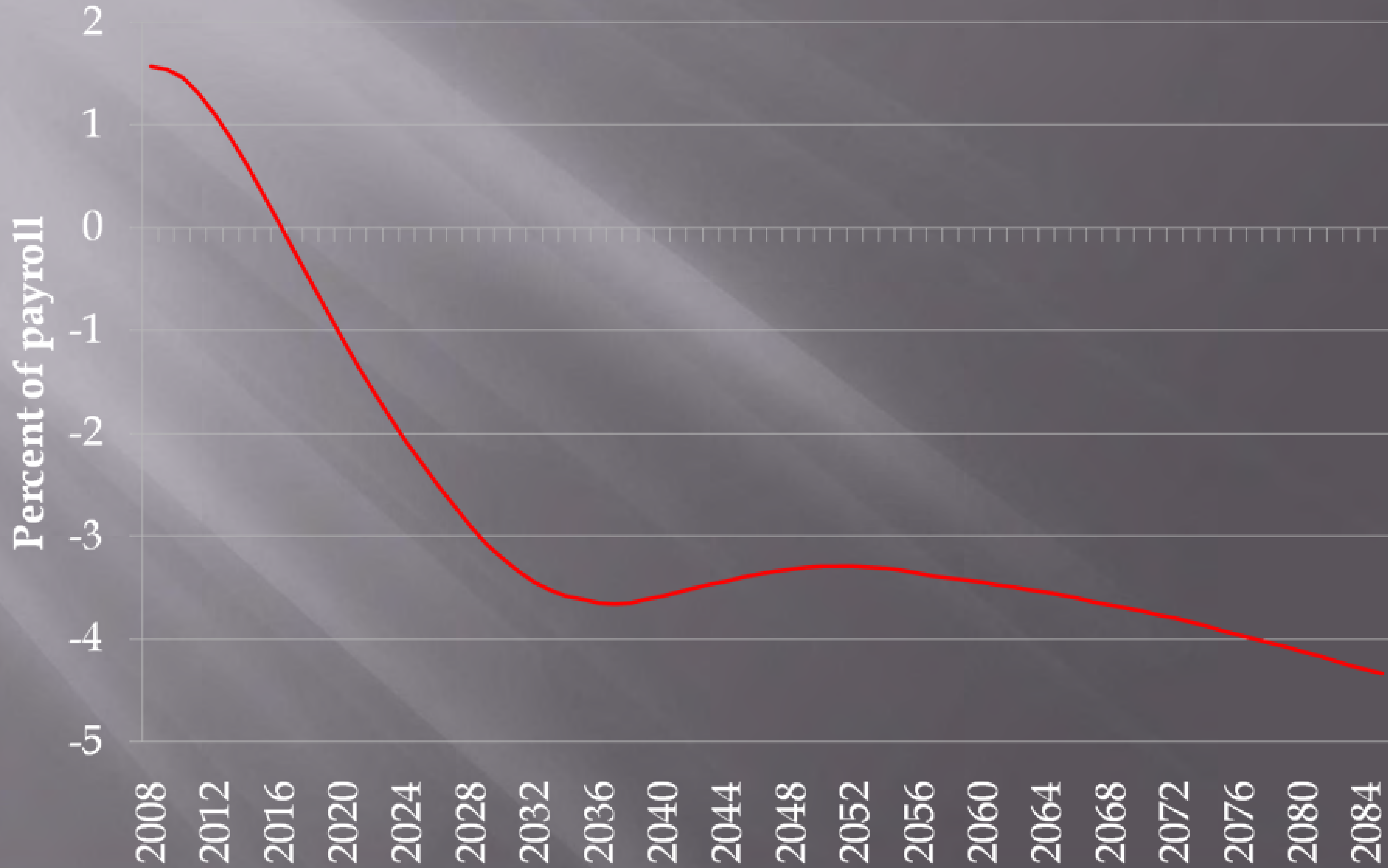
What is the problem?

- Pay-as-you-go financing:
  - Transfers from workers to beneficiaries
  - No saving/investment
- Fewer workers, more beneficiaries
  - 5-to-1 ratio in 1960l 3.3-to-1 today; 2-to-1 in the future.
- Why?
  - Lower birth rate means fewer new workers
  - Longer life spans means more beneficiaries

The bottom line

- System will run deficits beginning in around 2017
- By 2030, annual deficits equal $270 billion ($2008)
  - Financed by repayment of trust fund; requires tax increases, spending cuts or borrowing
- Trust fund projected to be exhausted in early 2040s
  - After exhaustion, benefits would be cut by around 25%

Social Security cash flow



What about the trust fund?

- Invested in special-issue government bonds
  - Asset to Social Security; liability to rest of the government
- Social Security can redeem with Treasury once deficits begin around 2017
- Treasury must repay bonds
  - Requires tax increases, spending cuts, or borrowing
- Trust fund does not reduce pressure on overall federal budget

What are our choices? (Part 1)

- Raise taxes
  - Pro: Social Security only guaranteed retirement income; extra taxes are worth it
  - Con: Higher taxes hurt economy, reduce personal retirement saving
- Reduce benefits
  - Pro: We could still pay higher benefits than *today's* retirees get; individuals could save more to make up difference
  - Con: Many low earners won't save on their own; poverty could increase

What are our choices? (Part 2)

- Increase retirement age
  - Pro: People are healthier and living longer; working a few more years makes sense
  - Con: People in poor health can't continue working
- Reduce Cost of Living Adjustments (COLAs)
  - Most economists think COLAs overstate true inflation
  - Effect compounds over time; biggest reductions for oldest retirees

What about personal accounts?

- Could be 'carved out' of existing payroll tax, or 'added on' with additional funds
- No direct effect on system
- Diversify retirement portfolio
  - Low earners don't hold stocks; gives them chance to earn higher returns (with higher risk!)
- Better form of saving
  - Instead of tax increases, require people to pay extra contributions to own account

Wrapping up…

- No easy solutions
  - Personal accounts won't fix problem, as some on right say; system won't fix itself, as some on left say
- Reform will be a package deal
  - No single fix will be enough; menu of small reforms most likely
- Reform requires leadership from both parties
  - Neither side can win on its own; must be willing to talk, compromise