**M. Edith Rasell, M.D., Ph.D.**
**Economic Policy Institute**
**Funding of the Social Security Program**
**March 1, 1999**

Good morning. I am Edith Rasell, an economist at the Economic Policy Institute. Thank you for the opportunity to testify about additional revenue sources for Social Security. I will briefly summarize my remarks then begin by examining the five options you requested us to discuss.

To strengthen Social Security, the nation should devote a large portion of the federal budget surplus to the Social Security trust fund. We must also raise the cap on earnings subject to the Social Security payroll tax. Eventually we will also need to raise the payroll tax rate. More fundamentally, we must raise the level of public investment. This will strengthen the future economy and better equip the nation to meet its obligations.

**Options for Additional Revenue**

***Increase the taxable wage base:*** To increase revenue for Social Security and reduce the regressivity of the payroll tax, the taxable wage base should be expanded to include a larger share of earnings.

Currently, Social Security payroll taxes are levied on earnings up to $72,600 only. The cap on earnings is raised each year at the rate of growth in average earnings. However, over the past 20 years, wages and salaries at the top of the earnings distribution have been growing faster than in the middle or the bottom As a result, a growing share of all earnings exceed the cap. Raising the cap on earnings would increase revenue for Social Security and make the payroll tax less regressive.

In the early 1980s, fully 90% of earnings were subject to the Social Security payroll tax. Now the share is about 87% and the Trustees project it will fall further to 85.7%. Raising the cap and maintaining it at a level to include 90% of earnings (while also raising benefits accordingly) would close the Social Security 75-year projected shortfall by about 0.55 percentage points, or one-quarter of the total. This is the minimum amount by which the taxable wage base should be increased. It would also be appropriate to tax all earnings, as the Medicare payroll tax does, (this would close about three-quarters of the shortfall), and extend the Social Security tax to unearned income.

***Increase payroll taxes:*** The Social Security program will need additional funds in the future. For the time being, a part of the federal budget surplus can and should be earmarked for the trust fund and a tax increase can be delayed. But, ultimately, we will probably need to raise the tax rate.

Since two-thirds of the projected funding shortfall is due to people living longer, an appropriate way to raise the tax rate is to index it to longevity. For example, we could increase the tax rate by 0.02 percentage points each year, applied to both the employer and employee shares of the tax. After one year, the payroll tax would be 6.22%; after 10 years, it would have increased to 6.4%. It would take 50 years to rise a full percentage point to 7.2%. (While taxes were rising by 0.02 percentage points each year, the Trustees project real wages will grow 0.9% to 1.1 % each year, about 50 times faster.) This small tax increase would eliminate about two-thirds of the funding shortfall over the next 75 years.

***Taxing benefits more like private pension income****:* In private pension plans, benefits received by each individual in excess of their contributions are subject to taxation. It has been proposed that this practice be extended to Social Security, replacing the current policy of taxing 85% of benefits.

If this proposal were adopted, low- and moderate-income beneficiaries would see the largest increase in taxes. Social Security redistributes income from high-earners to low and moderate ones. It is these low- and moderate-income beneficiaries who receive the largest benefits *relative to their contributions.* Consequently, under this proposal they would be taxed on a larger share of their benefits than higher-income beneficiaries. Their tax liability would likely increase while that of higher income beneficiaries fell. The 85% rule should be retained along with the tax exclusion for benefits received by single people with incomes below $25,000 and couples below $32,000.

***Recapture revenue now devoted to the Hospital Insurance trust fund for the Social Security trust fund****:* The shortfall in the Medicare HI trust fund (2.1 % of payroll) is roughly the same size as the Social Security trust fund shortfall and the revenue increases needed for Part B are even larger. We should not shift money from Medicare to Social Security.

***Decrease the payroll tax****:* Since the system is inadequately funded over the long term, this would be a move in the wrong direction.

**President Clinton's Social Security Proposal**

***Spending 62% of the 15- Year Surplus for Social Security****:* The President proposes paying the trust fund fully 62% of the federal budget surplus over the next 15 years, a total of $2.7 trillion. The trust fund needs additional revenue and federal revenues exceed budgeted expenses. Therefore, part of the surplus could and should be used to increase the trust fund balance.

However, given the nation's other pressing needs, 62% is probably too much. As mentioned, the Medicare program including both Parts A and B has a long-term funding deficit that is larger than Social Security's. The President's proposal to devote 15% of the surplus to Medicare is entirely inadequate. The nation also needs to be making the public investments now that will build a strong economy in the future so that we can more easily pay the costs of Social Security and Medicare. Some of the surplus should be explicitly devoted to increase public investment.

Some critics have labeled the President's plan for Social Security double counting or sleight of hand. But what is being proposed withstands rigorous scrutiny. Much of the future federal budget surplus (and a of it in FY 2000) comes from the Social Security trust fund. By law, the trust fund must buy U.S. treasury bonds with the excess. The sale of these bonds by the treasury to the trust fund generates revenue for the treasury Oust as does the sale of bonds to private investors) that can be used to pay for education, Medicare, the military, and all the other things purchased by the federal government. The President is proposing that some of this money be devoted to Social Security, that is, be given to the trust fund. When this happens, since Social Security will not need to spend the money now, the trust fund will use it to purchase treasury bonds and the money will flow back to the treasury. But the federal budget presents no plan for spending this money. On the contrary, it is earmarked for reducing the debt held by the public. In short, publicly-held debt will be replaced, dollar for dollar, by debt held by the trust fund. Although complicated, there is no double counting and nothing that differs from past practices. The nation is reducing the federal debt today with the expectation that when money is needed in the future to pay off the bonds held by the trust fund (or by private investors), we will have the option of borrowing as well as raising taxes.

***Buying Equities:*** President Clinton also proposes buying equities with some of the money in the trust fund -- a policy that should be opposed. Government stock market investments pose special problems. The one that has received the most attention is the possibility that the federal government in its role as shareholder could try to influence the behavior of firms. However, the President proposes that the equity investments be made exclusively in broad-based index funds Eke the Wilshire 5000. This would probably preclude the possibility that the government could exert influence on firm behavior through its role as shareholder.

A more fundamental problem with this proposal is that these investments could foster in policy makers a concern with stock market performance that might supercede a broader goal of economic policy: to promote healthy and sustainable economic growth that benefits all Americans. It is for this reason that the trust fund should not invest in equities.

***Over-stated Stock Market Returns:*** Both the President's proposal that the trust fund purchase equities and proposals for individual accounts that would permit workers to invest some or all of their Social Security payroll taxes in the stock market share a common flaw. They greatly overestimate the returns that will be received in the stock market in the future. Most analysts assume that the inflation adjusted, average, annual rate of return on stocks over the next 75 years will equal the rate of the past 75 years, 7.0%. (The President's budget assumed a return of 6.75%.) But if economic growth over the next 75 years averages half the rate of the past 75 years, as projected by the Trustees, then returns on stock will average only about 4.0%, not 7%[1]. Moreover, in individual accounts, transaction and brokerage fees will absorb 1% to 2% of the value of the account each year, leaving an actual return of 2% to 3%. In comparison, the Trustees project treasury bonds will pay about 2.8% on average. There will be little advantage to the average individual account holder from investing in equities. Equity investments by the trust fund could potentially bring a higher return than treasury bonds since fees will be much lower. However, the small difference is probably not worth the risks that would be incurred.

**Social Insurance, not an Investment**

There has been much interest in the estimated internal rate of return of the Social Security program compared with various reform proposals. But these calculations do not accurately reflect Social Security's value to workers which is more than the monetary benefits received. Social Security is a social insurance program, not an investment plan. It provides a real-valued annuity to retirees - that is, retirees receive an annual payment, adjusted each year for inflation, that will continue throughout their lifetimes. Such an insurance product is rarely available in the private market. Moreover, the annuity provided by Social Security automatically covers dependent spouses after the death of the primary beneficiary. Social Security also provides disability insurance and benefits to survivors of deceased workers. To see Social Security solely in terms of the monetary benefits received is to grossly understate its value.

**Meeting Obligations in the Long Term**

Before concluding, I want to briefly look at the big picture. Federal government debt increased over the 1980s and early 1990s. If the Social Security trust fund had not loaned money to the U.S. treasury, borrowing from the public would have been greater. But total debt, including both public and private, would have been unchanged. As this debt comes due, the nation will have two options for coming up with the cash: raising taxes or borrowing. The larger and more fast growing the economy, the better able the nation will be to meet these obligations without borrowing. At this time, the federal government should be doing everything possible to strengthen the future economy so that workers will have higher incomes and be able to pay higher taxes while still enjoying a rising standard of living. To achieve this goal, we should be >making large public and private investments. Private investment has grown in recent years. But public investment measured as a share of GDP - including expenditures for education and training, infrastructure, and research and development - is 1 to 1 ½ percentage points below the level of the 1980s and early 1990s according to the Office of Management and Budget. It is over 3 percentage points below the level of the 1960s. Over the next five years, public investment will remain a fairly constant but small share of GDP. To strengthen the future economy, we should increase public investment. In a growing economy with broad-based wage growth, taxes can rise while living standards also climb. We need to do everything we can today to ensure that this will be our future.

**Endnote**

[1] This assumes that dividends as a share of stock price remain at their current level of about 2.5% and that stock prices which track dividends which, in turn, track corporate profits which, over the long run, must track economic growth will rise by 1.5% annually, the Social Security Trustees' projection for economic growth over the next 75 years. (See Dean Baker, *Saving Social Security with Stocks: The Promises Don't Add Up*, Washington DC: Twentieth Century Fund/Economic Policy Institute, 1997.)