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INSIDE THE VAULT | FALL 1997
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Social Security: Who Will Fund Your Nest Egg?

An issue that has captured the attention of baby boomers, Generation Xers and retirees is that of Social Security. Will it be there for you? Who will pay for it? To answer these questions, let's take a look at why the current public pension system was established and how it operates. Then we'll explore some of the proposed changes that meet the challenges of the Social Security System.

Feathering Your Own Nest

Prior to the creation of a public pension system, individuals relied on their savings or family and community members to help them during their retirement years. Demographic changes during the early 20th century, such as increasing life expectancies and migrations of workers from farms to cities, contributed to the declining support from family and community. These factors and employment difficulties faced by older workers increased pressure on the federal government to create a public pension system. The Great Depression of the 1930s in which older workers were often the first to be laid off and the loss of retirement savings due to the stock market collapse precipitated the establishment in 1935 of the U.S. public pension system—commonly referred to as Social Security. In addition to providing relief to the elderly, a goal of the 1935 U.S. Social Security Act was to encourage elderly workers to retire, creating vacancies for younger workers and reducing unemployment. In this way, younger workers as well as older workers benefited.

Building the Birdhouse

The U.S. public pension system operates as an inter-generational transfer. This pay-as-you-go system means that contributions by current workers are used to pay the benefits for current retirees. Each generation of workers supports the previous generation with the implicit understanding that the next generation of workers will support their retirement, forming a chain of inter-generational transfers. To qualify for a public pension, a worker must have reached a certain age and have contributed to the system for a minimum number of years. Individuals may retire early, but with a reduction in benefits. Benefit payments increase with the number of years worked.

The pension program is financed through payroll taxes. Current employees and employers each pay a payroll tax, with an upper limit on taxable earnings. Currently these tax revenues exceed payments to beneficiaries, and the surplus is placed in a trust fund invested in government securities. According to the 1997 Annual Report of the U.S. Social Security Board of Trustees, contributions from workers will cover payments to retirees until 2012. After this date, monies from the trust fund will be used to finance the shortfall in contributions. At this rate, the trust fund will be depleted by 2029, and contributions will cover only 75 percent of payments to beneficiaries. Without an increase in taxes or a reduction in benefits, government revenues will have to be reallocated from current programs to make up the Social Security deficit.

One of the major factors creating the projected shortfall is the ratio of contributors to beneficiaries. In 1950, there were approximately 7 contributors per beneficiary.

That number will drop to about 5 contributors per worker in 2000 and 2 contributors per worker in 2050. In addition to the number of workers paying into the system and the number of retirees, other components that affect the balance of revenues and payments are payroll tax rates, wages and the level of benefits. Because payments are indexed—adjusted for inflation—price levels also affect the balance.

Protecting the Nest Egg

Given the projected deficits and possible depletion of the Social Security Trust Fund in the not-so-distant future, ideas about how to reform the System are up for debate. One proposal is based on maintaining the pay-as-you-go structure, with some of the following changes:

- Increase the retirement age
- Increase the work years required for full benefits
- Reduce the incentives to retire early
- Reduce monthly benefits to new retirees as life expectancy increases
- Increase the taxability of benefits
- Reduce the indexation of pensions
- Raise the contribution tax or broaden the tax base

An alternative to the current intergenerational transfer is that of moving to a more fully funded, two-tier system. This type of reform generally includes a portion of the pay-as-you-go system to guarantee a minimum pension for all retirees—the first tier—but would be supplemented by workers' mandated contributions to a private pension to fund their own retirement—the second tier. Benefits under the first tier would be assured by the government; benefits under the second tier would depend upon the return on one's investments. In the United States, 42 percent of the elderly would have incomes below the poverty line were it not for public pension benefits. Thus the two-tier system must have a first-tier substantial enough to provide a cushion against the market risk inherent in the second-tier benefits. At the same time, however, the first-tier must be modest enough to provide a solution to the problem of the projected shortfall.

Who's Minding the Nest?

In 1965, the U.S. Congress amended the Social Security Act to require that an Advisory Council be established every four years to analyze the long-term health of the Social Security System. The 1994-96 council was asked to focus on the long-range financial status of the program, the adequacy and equity of the benefit structure across generations, income status and family situation, and the roles of the public and private sectors in providing retirement income. Council members reportedly agreed that the system needs to move away from a pay-as-you-go approach toward a more fully funded system of financing retirement. Members were unable, however, to develop a single proposal to which all could agree.

Clearly, the current balance between costs and benefits of our public pension system is unsustainable. The sooner policymakers reform the System, the greater the ease of transition for the System as a whole, as well as for the individual in building his nest egg.

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Q & A

What effect do immigrants have on the wages of native-born Americans?

The basic principle of supply and demand would suggest that increases in the labor supply would decrease the price of labor, that is, wages. This principle holds true if all workers possess the same skills. In fact, workers have different skills, and studies have shown that over the past 20 years only native high school dropouts have experienced a decline in their wages because of immigration.

What impact do immigrants have on government budgets?

The most striking difference between immigrants and natives is not in benefits received, but rather in taxes paid. Both immigrants and natives get about the same amount of government benefits during childhood and retirement, when most benefits are received. During the working years, however, the amount of taxes each group pays is quite different. Recent immigrants pay the least, but their children—who tend to make more money and live in high-income/high-tax states—pay the most. Thus, although some immigrants may pose an initial fiscal burden, the U.S. economy, in the long run, benefits from immigration.

What effect do immigrants have on the U.S. economy?

A recent National Research Council report, authored by a panel of economists and sociologists, shows that Americans are generally not losing jobs because of immigrants. Actually, immigrants are increasing economic growth by bringing with them skills that widen the variety of goods the economy can produce. Each year, new immigrants add between $1 billion and $10 billion to total U.S. output.

Are more immigrants entering the United States now than ever before?

That depends on whether one is counting absolute numbers or looking at the percentage of population. The number of immigrants entering the United States legally is greater today than it was in the early 1900s. The current rate of U.S. immigration—the level of immigration adjusted for population—however, is much lower today than it was a century ago. Between 1900 and 1910, about 11 immigrants per thousand residents entered the United States legally. The current rate is about five per thousand, but rising.

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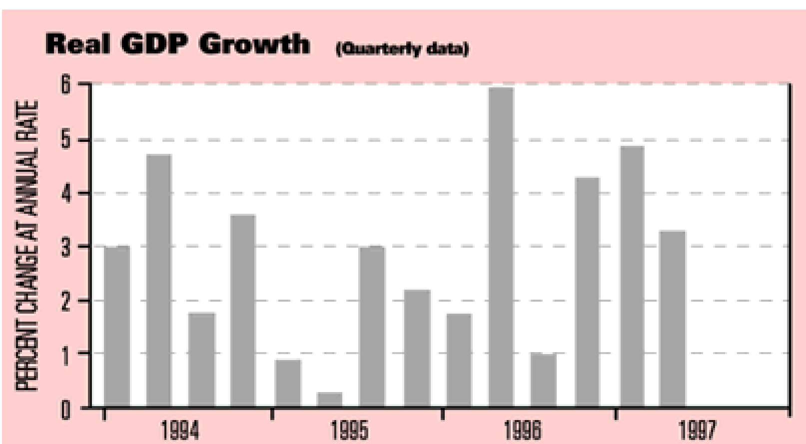
Economic Snapshot

3rd Quarter 1997

	Q4-96	Q1-97	Q2-97	Q3-98
Growth Rate—Real Gross Domestic Product	4.3%	4.9%	3.3%	3.5
Inflation Rate—Consumer Price Index	3.3%	2.4%	1.1%	2.0%
Civilian Unemployment Rate	5.3%	5.3%	4.9%	4.9%



SOURCE: National Economic Trends*, Federal Reserve Bank of St. Louis, October 1997, p.3*

What does Real GDP measure?

Real Gross Domestic Product measures the value, adjusted for inflation, of a country's output of final market goods and services during a year. In contrast, Nominal GDP is expressed as a dollar value not adjusted for inflation. "Final" goods and services ensures that an item is counted only once For example, tires that are on an automobile produced in 1997 are included in the dollar value of the car. If the tires were counted first as tired production and then as part of the car's value, GDP would be overstated.

Economists measure real GDP as a money amount in base-year dollars. They choose some past year, such as 1992, to calculate the value of the economy's current output. Real GDP in base-year dollars show what the money value of the current output would be if prices had not changed since that base year, and enables us to compare real output over time.