

## TIPS for Social Security?

The largest retirement plan in the United States is the Old Age, Survivors, and Disability Insurance (OASDI) program of the Social Security Administration. During 2004, 48 million persons received \$493 billion in benefits, and 157 million persons with earnings subject to the program's payroll tax furnished the bulk of the program's \$658 billion income. The \$165 billion in excess revenue was added to the program's trust fund, which at the end of 2004 totaled \$1.7 trillion.

During the next 25 years, it is projected that the OASDI program's ratio of beneficiaries to taxpayers will decrease from its current 3.3 to 1 to about 2.2 to 1. As a result, it is projected that outlays will persistently exceed revenues after 2018 or so. Under current tax and benefit rules, and by drawing down the trust fund, it is projected that all scheduled benefit payments can be made for at least the next 25 years, at which time the trust fund will be exhausted. Thereafter, if no changes are made to benefits or taxes, it is projected that incoming tax revenue will be sufficient to fund about 70 percent of scheduled benefit payments through 2080. Many analysts (and politicians) have argued that this shortfall is unacceptable and that the OASDI program must change. Proposals include increasing the payroll tax, reducing benefit levels, increasing earnings on the trust fund's investments, and delaying the age at which new retirees are eligible for full benefits. Economic analysis suggests it is important to analyze these proposals carefully because each is likely to have different effects on various groups in the economy.

Consider, for example, the Social Security trust fund. Prior to 1983, the OASDI program operated largely as a pay-as-you-go system. Established by Congress in 1940, the program's trust fund grew little prior to 1983 as a result of Congressional deferrals of proposed tax increases.<sup>1</sup> In 11 of the years between 1940 and 1983, the level of the fund decreased as benefit outlays exceeded revenues. In 1983, the Greenspan commission on OASDI recommended that the program be changed from one in which benefits were paid solely from current revenues to a partially funded retirement plan. Payroll tax rates were increased, and the trust fund began to grow. Recently, some analysts have proposed that the trust fund ought to seek to earn a higher rate of return so as to mitigate the future OASDI shortfall. This proposal is problematic

because the fund consists solely of Treasury securities. Not until benefit payments begin to exceed payroll tax revenues, say in 2018, will the Treasury be required to redeem these securities and transfer funds to OASDI. How the Treasury chooses to raise those funds will have tax-incidence implications. Increases in income taxes, to fill the Treasury's general fund for payment to OASDI, will fall more heavily on upper-income households; decreases in OASDI benefits or increases in payroll taxes will fall more heavily on lower-income households.<sup>2</sup> Hence, higher rates of return credited to the trust fund by the Treasury during the next several decades would have the effect of transferring more of the burden of resolving the OASDI shortfall to higher-income households.

Current law sharply limits the trust fund's investment options: The fund is permitted to invest solely in securities backed by the full faith and credit of the federal government. In practice, each year the fund purchases nonmarketable Treasury securities with maturities varying from 1 to 15 years, at a yield equal to the average market yield on Treasuries with 4 years or more to maturity. In 2003, the fund purchased \$210 billion at a 3.5 percent yield; in 2004, the fund purchased \$215 billion at a 4.6 percent yield. Some analysts have suggested that the trust fund's investments should more closely resemble those of private retirement systems by including long-maturity inflation-indexed securities. A few of these proposals suggest that the Treasury be required to issue, to the trust fund, long-maturity Treasury inflation-protected securities (TIPS) with above-market yields. Although controversial, such a change would shift the tax incidence of resolving a substantial portion of the OASDI shortfall from lower-income to higher-income households. Simple calculations, using current benefit and tax projections, suggest that the trust fund's exhaustion date likely might be delayed to as late as 2080 if the entire current fund were invested in such special-issue TIPS at a real coupon rate of approximately 5.5 to 6 percent.

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<sup>1</sup>Technically, the OASI trust fund was established in 1940. The DI fund came later.

<sup>2</sup>This discussion assumes that the Treasury will not be able to fund its entire obligation by marketing new securities to the public and, hence, at some point will require higher income taxes.