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SOCIAL SECURITY - PRE-FUNDING IS NOT THE ANSWER

Abstract

Contrary to the claims of conservative critics, Social Security is affordable and its benefits are not excessive either in terms of amount paid or age of retirement. Pre-funding Social Security through sustained budget surpluses represents unwise deflationary policy. Instead, Social Security’s problems are the result of relying on the wage base for funding. Funding a substantial portion of Social Security through general revenues would resolve these problems and bring a range of economic and policy benefits. It would encourage job creation, eliminate the deflationary bias inherent in the current system of partial pre-funding, enhance progressivity, and put a stop to the policy of using the regressive payroll tax to finance general government spending and tax cuts for the most affluent. The current moment provides an economically opportune time to implement the suggested plan since it would be stimulative to both household income and corporate profits, and it would significantly lower costs of employment.

Keyword: Social Security, wage base, general revenue.

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I Introduction: pre-funding is not the right answer

In a recent article Thomas Michl (*Challenge* , November - December 2001) has argued for using on-budget surpluses to pre-fund Social Security, with these surpluses being invested in private equities that would be held by the trust fund. This recommendation represents a hybrid of conservative and progressive elements. On the conservative side, Michl endorses the idea that Social Security should be pre-funded, and that pre-funding should take the form of investment in equities. On the progressive side, he recognizes that the Social Security tax is regressive, and argues that additional funding for Social Security should come from on-budget surpluses which are generated in more progressive fashion from general revenues.

Michl's principles are derived from a mis-understanding of the workings of a monetary economy, and they suffer from many of the flaws that infect conservative proposals for private accounts. The bottom line is that pre-funding is the wrong way to go. Instead, policy makers should cut the payroll tax and shift to financing Social Security out of general revenues. There are two reasons for such a shift. First, the Social Security payroll tax is regressive. Second, the payroll tax likely discourages employment creation, so that cutting taxes could promote sustained full employment and raise wages. Though superficially radical, a plan that cuts the payroll tax and shifts to general revenue funding may in fact satisfy a wide enough group of interests to support a grand bargain that ensures the future of Social Security for the next century.

Finally, though focused on the U.S. debate over Social Security, the economic arguments against individual accounts and pre-funding apply with complete generality to the global debate over public pensions. The arguments therefore apply with full critical force against the policies of the World Bank which has been a persistent advocate of pension privatization based on mandatory full funding. Using the euphemism of multi-pillar pension reform the bank has systematically pushed fully funded private accounts:

> "Multi-pillar reforms generally involve a full or partial diversion of contribution revenue away from the public pay-as-you-go system toward the funded second pillar. (World Bank, 2001, p.57)."

Such reforms are especially inappropriate for developing countries where fiduciary protections are weak, and contributions are small so that they are quickly eroded by administration costs.

II Context of the current debate

According to the 2001 Report of the Social Security Trustees, under current funding arrangements Social Security faces a long term funding shortfall over the next 75 years equal to 1.86% of taxable payroll.[1] Expenditure outgoes are predicted to exceed payroll tax inflows beginning in 2016, and the Trust Fund is predicted to become insolvent in 2038 – at which time its investments will have been liquidated and payroll tax inflows will only cover 70% of outgo.

This predicted funding shortfall has generated a significant national debate that raises economic and political questions about how best to provide for future retirees, as well as difficult public policy concerns of how to communicate these complexities to the public. At its core, the economic debate revolves around two separable issues. The first concerns whether the nation will have sufficient "economic pie" to meet the needs of future retirees and workers. The second concerns what is the right "transfer mechanism" for ensuring that an appropriately sized slice of economic pie actually gets into the hands of retirees. In this regard, different transfer mechanisms (such as private accounts) have dramatically different economic and political properties. Thus, transfer mechanisms differ regarding the riskiness and uncertainty of future retirement income, and they also differ regarding their vulnerability to change as a result of future political opportunism.

III The conservative critique and privatization: a case of the king has no clothes

Conservative critics of Social Security have seized on its long term funding shortfall to create a rhetoric of "crisis." Though never expressly articulated, behind this rhetoric lies the implicit claim that the ageing of America means that the nation lacks sufficient resources to support the existing system of Social Security owing to its excessive benefit levels. In its place,

[1]. Social Security's actuaries measure the shortfall in terms of the Social Security payroll tax rate. Thus, raising the tax rate by 1.86 percentage points from it current level of 12.4% to 14.26% would ensure actuarial balance over the next 75 years.

these critics propose the creation of a new retirement income system in which Social Security contributions would be directed to private investment accounts.

The conservative argument that Social Security is no longer affordable is usually constructed in terms of the fact that there will be a large increase in the number of retirees per active worker over the next seventy five years. Whereas in 2000 there were 3.4 covered workers for every Social Security beneficiary, in 2075 this number is predicted to be just 1.9.[2] However, an alternative way of evaluating the burden of Social Security is in terms of the dependency ratio which measures the ratio of economic dependents to the working age population. Table 1 shows that though the aged dependency ratio is predicted to rise steadily, the total dependency ratio (which includes those under 20) actually peaked in 1960 at 0.904 and will only be 0.842 in 2075. Elsewhere (Palley, 1998) I have also shown that if measured in terms of "effective" workers (i.e. in terms of the number of workers adjusted for changes in the level of labor productivity), the dependency ratio in 2075 will be even more substantially lower than it was 1960.

Another angle on the question of whether the nation can afford Social Security is obtained by examining real wages. Assuming per capita income growth to average 1.5% per annum over the 115 year period between 1960 and 2075, per capita income will have risen 450% by 2075. If real wages grow at the rate of 1.5% a year as predicted by the Social Security trustees, average pre-tax real wages will be 200% higher in 2075 than they were in 2000. Even if workers in 2075 have to meet the full trust fund shortfall and face a payroll tax rate of 19.39%, they would still be 181% better off.[3] The bottom line is that per capita income has risen steadily for the last fifty years, and it will continue to rise steadily for the next fifty. This makes a nonsense of the claim that we as a society cannot afford Social Security.

Affordability is not the problem. That said, there is a different problem concerning the

[2]. Source: Report of the Trustees, 2001, p.48.

[3]. If real wages in 2000 are indexed at 100 and they grow at 1.5% per annum over the next 75 years, real wages will be 305 in 2075. The payroll tax rate in 2000 was 12.4%, making for an after-tax real wage of 87.6. According to the 2001 Trustees' report (p.144) the required payroll tax rate in 2075 is 19.39%, making for an after-tax wage of 245.9, making workers 181% better off relative to 2000.

funding shortfall. However, the scale of this shortfall is a world away from conservative rhetoric of crisis and Social Security being unaffordable. A sense of proportion regarding the shortfall can be obtained by comparing the predicted size of the 75 year shortfall with the Bush tax cut of Spring 2001. The Bush tax cut exceeds 1.5% of GDP when fully phased in, whereas Social Security's funding shortfall average just 0.73% of GDP over a 75 year horizon.[4] Moreover, if the economy grows under the slightly more favorable demographic and economic assumptions embodied in the low cost Trustee estimates, the funding shortfall disappears entirely.

Not only are conservatives' claims that Social Security is unaffordable unfounded, but conservatives then compound their flawed analysis by proposing that private accounts become the system of retirement income delivery. This will increase the risk that retirement income fails to get to those who need it. Moreover, proposals for private accounts also involve cannibalizing the system of disability and survivor insurance that Social Security also provides.

One claim made on behalf of private accounts is that they would raise national saving and capital accumulation. The argument is that individuals reduce private saving because they view Social security as saving on their behalf. Eliminating Social Security would therefore raise private saving which would raise capital accumulation (Feldstein, 1974).

According to the Keynesian economic model this claim is not supported because investment drives saving. Capital accumulation in the U.S. has not been constrained by a shortage of saving, but rather by a shortage of investment demand. Thus, to the extent that Social Security increases consumption spending by making individuals feel wealthier and more secure, it may even crowd-in investment.

Not only is the conservative claim wrong in terms of the Keynesian model, it is also wrong according to the Classical full employment model. National Saving is made up of private and public saving so that

(1) $S = S_{priv} + S_{pub}$

[4]. The funding shortfall is estimated at 1.86% of taxable payroll, and taxable payroll in 2001 was 0.397% of GDP (Trustees' report, p.152). This is equivalent 0.73% of GDP (1.86% x 0.397).

where S = national saving, S_{priv} = private saving, and S_{pub} = public saving. Redirecting Social Security contributions away from government to private accounts reduces public saving, and generates a one-for-one shift between private and public saving. This means that private accounts have no net effect on national saving. Indeed, there is even reason to believe that private accounts may have a negative impact on national saving. Thus, suppose agents have a private saving target of S_{priv}^* and treat each dollar of Social Security saving as being less than one (i.e. they less than fully internalize saving done by Social Security on their behalf). In this case, when government saves one dollar on their behalf, private agents reduce their own saving by less than one dollar, so that aggregate saving increases.[5] $S_{priv} = S_{priv}^* - aS_{pub.}$ Where $0 < a < 1$. When government increases saving by \$1, private sector saving falls by \$a < 1. Conversely, replacing Social Security with private accounts would reduce government saving by a full dollar, but individuals would only increase their saving by less than a dollar to restore their target level.[6]

Increased national saving and capital accumulation represents the conservative macroeconomic argument for private accounts. This is accompanied by an argument that private accounts can maintain the existing level of Social Security benefits owing to the high rate of return to equity investment. Historically, over the last 75 years, equities have yielded an annual average real return of 7%. Proponents of private accounts extrapolate this performance into the future, and argue that a 7% annual average return can cover Social Security's shortfall. However, these predicted returns are inconsistent with the economic predictions embodied in the Social Security Trustees' report (Baker, 1996; Palley, 1997). If the economy grows at the 1.5% rate predicted by the Trustees and profits grow in line with the economy, the only way that equities can earn a 7% return is through a massive equity price bubble that has price/earnings ratios

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[5]. Formally, such an outcome results from the following saving behavior

[6]. Balanced against this Social Security may have a negative effect on national saving if government uses contributions to increase government spending. It can also have a negative effect in the classical model if it is a pure pay-as-you go (PAYG) system. In this case there can be saving illusion in the sense that government is actually saving nothing, but individuals believe they are freed from the necessity to save because of their future Social Security entitlement.

explode. This is because equity prices must increase at a far faster pace than profits. Alternatively, if profits grow sufficiently faster than the economy to support higher equity prices at a reasonable price/earnings ratio, then the profit share will increase dramatically and the wage share will fall. As a result, contributions into private accounts will not grow as predicted. Finally, if high returns to equities are realized by faster than predicted growth of the economy and profits, then there is no funding problem with Social Security in the first place and private accounts are redundant.[7]

These financial consistency considerations are one dent in the rate of return argument. A second is the fact that private accounts will be subject to significant administrative costs - as has been exemplified by the experience with accounts in Chile and the U.K. - which will lower net returns. Diamond (1993) reports that administrative costs in Chile were 2.94% of taxable earnings, which is close to 30% of the Chile's 10% mandatory saving rate. Moreover, given that these costs are of a fixed nature, they stand to be especially burdensome on low income earners who will contribute proportionately less to their accounts.

Worst of all, private accounts are a flawed retirement income delivery mechanism because of their risk properties. Private accounts therefore increase risks while not even providing the same benefits. Social Security provides a guaranteed inflation proof retirement income for as long as one lives. This income can be viewed as part of a retirement income portfolio consisting of Social Security, private saving, and employer pension plans, and the tripartite structure of this portfolio means that retirement income is diversified. Private accounts replace the guaranteed real income component with a risky income that depends on a combination of stock market performance (market risk) and individual private investment decisions (investor risk). In addition, there is the possibility that retirees could exhaust their

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[7]. It is not just top-down macroeconomic analyses that place in doubt future stock market returns. A recent microeconomic paper by McGrattan and Prescott (2001) - who is the inventor of the equity premium puzzle - places in doubt whether stocks can appreciate at the same sizzling pace of the last forty years. This is because they argue that the increase in stock prices is due to a massive decline in marginal dividend tax rates which is unlikely to be repeated.

private accounts before they die (longevity risk). And nor are private accounts indexed against inflation (inflation risk). In effect, private accounts reduce the extent of retirement income diversification, exposing workers to greatly increased risk. With private sector pension arrangements and individual investor preferences already placing greater emphasis on stock market investment, such an approach to retirement income is sub-optimal.

A final issue is that Social Security is not just a retirement income arrangement. It is also a disability insurance arrangement. In 2000 almost 14% of Social Security's expenditures were in the form of disability insurance.[8] Once the cost of providing for disability insurance is figured in, the inability of private accounts to cover Social Security's shortfall without benefit cuts becomes even more visible. The true measure of Social Security is what would it cost to purchase identical coverage in terms of disability insurance and a guaranteed inflation-proof lifetime retirement income, and on this measure Social Security is a bargain buy.

IV A critique of public pre-funding with equity investment: the Michl proposal

Michl (2001) has proposed that Social Security should be pre-funded by investing the on-budget surplus in equities. Use of the on-budget surplus to pre-fund would be progressive since the surplus is generated out of general revenues which are raised in a more progressive manner than the payroll tax. At the same time, maintenance of Social Security means that public investment in equities does not give rise to the massive retirement income risk exposures associated with private accounts. Nor does it result in the elimination of Social Security's progressive benefit structure whereby lower lifetime wage earners receive a higher rate of return on their contributions. And nor does it result in the elimination of the Social Security disability and survivor benefit program. For all of these reasons, investing the on-budget surplus in equities is far superior to conservative privatization proposals.

That said, Michl's proposal suffers from a number of serious flaws relating to the principle of pre-funding with equities paid for by on-budget surpluses. A first problem is the

[8]. Per the 2001 Trustees' Report (p.44) the combined OASDI cost rate was 10.47% of payroll, while the DI cost rate was 1.43%.

reliance on budget surpluses to fill the predicted future funding shortfall. To begin with there is the practical issue that such surpluses have disappeared and been replaced by deficits, and it is an open question as to when and whether they will be restored. Beyond that, there is a deeper problem in that meaningfully funding Social Security through on-budget surpluses would be extremely deflationary and generate growing private sector financial instability. The reasons for this are discussed in my article, "The Case Against Budget Surpluses" which appeared in the same issue as Michl's article. The inevitable logic of the national income identity dictates that if the government is running large surpluses then the private sector must run large deficits or the country must run large trade surpluses. The former risks becoming unsustainable as private sector balance sheets deteriorate, while the latter would involve a U-turn that has zero likelihood of happening.

A second problem with equity pre-funding concerns the implicit vision of saving and its relation to investment. Michl's vision is predicated on a "corn" model vision of the economic process, whereby increased saving (corn not consumed) is immediately translated into investment (corn planted in the ground) to yield more income (corn) in the future. This is the implicit logic behind the claim that buying equities automatically results in investment.

This vision of the investment process is at odds with the reality of a monetary economy. Buying equities already in issue simply transfers money from the bank account of the buyer to the bank account of the seller, and does not result in more investment (capital accumulation). Dissecting the transaction in this fashion makes clear that it is investment that drives saving, rather than the other way around as assumed in corn model economics. Firms undertake investment spending by acquiring new plant and equipment, and this new plant and equipment gets counted as saving in the national income accounts. When GDP is broken down by expenditure category, new plant and equipment expenditures are counted as investment. But these expenditures also generate a matching receipt (in a market economy every purchase has a matching receipt), and when GDP is broken down by income category these matching receipts are counted as saving. The lesson is clear: generating higher investment and capital accumulation requires getting firms to undertake more investment spending.

The notion that equity pre-funding financed by on-budget surpluses can increase capital accumulation buys into the fallacies that have driven policies of fiscal austerity. For those who promote the virtues of surpluses as an end in themselves, the claim is that budget surpluses lower real interest rates, leading to more investment. Yet, empirically, the link between surpluses and lower real interest rates has not been substantiated, and the link between lower real interest rates and higher investment spending is also weak. The argument that purchasing equities will increase investment is based on Brainard and Tobin's (1968, 1977) *q* theory of investment whereby higher stock market prices are supposed to result in higher investment.[9] But here too empirical work suggests the link is almost non-existent (Von Furstenberg, 1977; Morck et al., 1990; Blanchard et al., 1993; Chirinko, 1993). In sum, not only does proposing to run budget surpluses to finance trust fund equity purchases promise no investment gain, it also threatens to lock us permanently into the paradigm of fiscal austerity, with all that it implies for inadequate public sector investment and service provision.

Finally, as with private accounts, public equity investment is also subject to the critique that future rates of return on equity stand to be much lower than they have historically been. In addition, there are two further political critiques of public equity investment. One is the Greenspan critique whereby public equity ownership risks turning into backdoor nationalization. The other is the danger that poor equity market performance could undermine confidence and support for Social Security. In this regard, it is easy to construct scenarios whereby Social Security's entry into the equity market drives prices up against the trust fund. Similarly, should the fund need to sell to smooth out demographic fluctuations in claims against the fund, or to make up for cyclically induced changes in fund revenues, this would drive prices down and create trust fund investment losses.

V Fixing Social Security means tackling the real problem of a declining wage base

[9]. Palley (2001) reviews the microeconomics of *q* theory, as well as the recent empirical literature.

The fact that the conservative critique lacks logical consistency, and the fact that conservative proposals for private accounts represent bad policy that exposes workers to hugely increased risks, does not mean that there is nothing wrong with Social Security. Though Social Security's existing benefits are clearly affordable from a national economic standpoint, there is a problem regarding existing funding arrangements. Tackling this problem requires understanding why the predicted shortfall has come about.

The principle reason for the shortfall is the erosion of taxable wage base owing to changing patterns of compensation, wage stagnation, and widening wage inequality. One cause of the shortfall is a decline in the proportion of persons in covered employment. According to the 2001 Trustees' report (p.97) the proportion of men in covered employment is predicted to fall from 74.7% in 1999 to 71.5% in 2075, while the proportion for women falls from 63.4% to 62.3%. Side-by-side with the decline in covered employment, is a decline in the proportion of earnings in covered employment that are taxable. In 1983 90.2% of earnings in covered employment were taxable, but this had fallen to 84.3% in 1999 (p.98). Moreover, it is predicted to continue falling at the rate of 0.1 percentage points per annum through 2075, at which time only 76.8% of earnings will be taxable. The net result is that taxable payroll relative to GDP is predicted to fall from 39.7% in 2000 to 34.6% in 2075 (p.152).

Social Security derives its revenues from taxation of wage income of individuals in covered employment up to a maximum of $80,400.[10] This taxable wage base has been subject to different forms of erosion. First, there has been the shift to forms of non-covered employment. Second there has been a shift in compensation away from wages to non-taxable forms of incentive compensation such as stock options. Third, there has been a widening of wage income inequality, and since individuals only pay Social Security payroll tax on income up to the cap of $80,400, the shift of wage income to upper wage groups has shifted more of the wage base above the cap. Not only has widening wage inequality reduced revenues, it has also added to costs

[10]. The taxable wage ceiling is indexed to CPI inflation and is adjusted every year. The $80,400 figure is the ceiling for 2001.

because of Social Security's progressive benefit structure that gives a relatively higher rate of return to low wage contributors. Finally, real wage stagnation and predicted slow growth of real wages also makes for shortfall because of the continuing PAYG dimension of Social Security. Whereas benefits are indexed to CPI inflation, revenue growth is driven by real wage growth. Consequently, stagnation of real wages has reduced the gap between revenue and benefit payment growth.

The effect of these effects can be sensed from the following 75 year sensitivity calculations. Eliminating the cap on taxable wage income would bring in an extra 1.63% of taxable payroll, eliminating 88% of the currently predicted shortfall.[11] An increase in the 75 year annual average rate of real wage growth from 1.5% to 2% raises 0.51% of taxable payroll, eliminating 27% of the shortfall. These calculations show how Social Security's funding shortfall is directly linked to its funding via the wage base. Whereas such a funding mechanism was appropriate in an earlier economic time, it is inappropriate in a modern financial globalized economy in which the wage base is subject to numerous forms of leakage that stand to increase in the future.

The above arguments make clear that it is not Social Security's benefits side that is problematic, but rather its funding side. Reliance on the wage base exposes Social Security revenue to an on-going process of leakage, and it is this problem that must be solved. The existing benefits formula should remain unchanged, with benefits continuing to be calculated on the basis of the taxable wage in covered employment. However, the funding base should be changed as follows:.

1. Social security should retain the employee contribution, but it should be assessed at 4% of taxable wages. It could also be longevity indexed.

2. The cap on taxable earnings should be eliminated, while the existing maximum benefit level is retained.

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[11]. Social Security: Why Action Should be Taken Soon, Social Security Advisory Board, July 2001, p.26.

3. The employer contribution should be entirely eliminated.

4. The trust fund should shift back to a one hundred percent PAYG basis, with the balance between outgoes and employee contributions being provided from general revenue.

5. To the extent that additional general revenues are needed these should be raised by increasing top rates of income tax. If the above program were implemented in 2002, an upper limit back-of-the envelope estimate is that income tax rates would need to increase by 16%.[12]

Such a funding arrangement has multiple economic and political benefits. First, it would fully and permanently close Social Security's funding shortfall, taking Social Security off the table once and for all. The conservative case for destroying Social Security has benefitted from the fact that Social Security's funding shortfall has been in the news persistently, year after year, and this has contributed to a deepening and mistaken public impression that it is unaffordable.

Second, the fact that the employee contribution is partially retained constitutes good political economy in that it keeps the link between payments into the trust fund and receipt of benefits. This creates a sense of ownership, and is consistent with Franklin Roosevelt's belief that it would be politically impossible to take Social Security away if workers know that they have paid for it. Moreover, it also ensures that Social Security continues to be a contribution based pension fund, which avoids the charge that it is welfare.

Third, by automatically funding any gap between outgoes and employee contributions from general revenue, Social Security's vulnerability to wage base erosion is eliminated. If the wage base erodes, needed funds are automatically provided from general revenues. The reliance on the wage base for funding reflects an earlier economy in which wage compensation dominated. This is changing. Yet, the need for Social Security has not changed. The logical

[12]In 2000 OASDI contributions were $418 billion (Trustees report, p.16). Lowering the employee payroll tax rate to 4.2% and eliminating the employer contribution results in a loss of revenue of $276 billion. Subtracting the Social Security cash in-flow surplus of $80 billion, this leaves $194 billion to be funded. In 2000 federal personal and corporate tax receipts were $1,244 billion. Raising an additional $194 billion requires a 16% increase in tax rates. However, the actual increase would be considerably less because (1) the elimination of the cap on employee contributions would raise significant revenue, and (2) corporate tax revenues would increase because profits would increase owing to the elimination of the employer contribution.

implication is change the manner in which Social Security is funded.

Fourth, the suggested reform improves the progressivity of Social Security. Though the regressive employee contribution remains, it is significantly reduced. More importantly, funding the balance of Social Security out of general revenues is progressive owing to the structure of the income tax and the fact that income tax is assessed on all sources of income (earned and unearned). The elimination of the wage cap is also progressive, and a significant part of the foregone employer contribution would be recouped through business income taxes on higher profits.

Fifth, the shift to PAYG financing eliminates the deflationary bias in the current system of partial pre-funding of Social Security. Partial pre-funding, which was introduced by the Greenspan Commission of 1983, has meant that the Trust fund has run persistent surpluses. In fiscal year 2000 the OASDI surplus net of interest receipts was $80 billion or 0.8% of GDP. This surplus in turn contributed to the record federal government surplus of $236 billion or 2.4% of GDP. The record surplus has exerted a fiscal drag on the economy and contributed to the current downturn, and to the extent that Social Security will run surpluses for the next decade it is contributing to a long term deflationary outlook.

Sixth, the shift to PAYG eliminates the current condition whereby the regressive payroll tax has been used to finance an increasing share of government spending and tax cuts for the rich. This strategy was first put in place during the Reagan administration through its adoption of the Greenspan Commission's recommendation to increase Social Security pre-funding. It is now being used by the Bush Administration which intends using the trust fund surplus to cover tax cuts for wealthy individuals and corporations. The pattern is clearly visible in figure 1 which shows how the off-budget surplus has increasingly financed on-budget outlays since implementation of the Greenspan Commission's recommendations.

Seventh, and finally, the elimination of the employer contribution will contribute to the creation of a favorable job environment and discourage corporate America from shifting jobs offshore. The Social Security payroll tax is a job tax to the extent that workers do not fully internalize contributions as income (they are not indifferent between the payroll contribution and an equal amount of additional wage income), and the employer contribution unambiguously raises the effective cost of employment for minimum wage jobs. Consequently, the payroll tax reduces the demand for labor, and it also give firms an incentive to shift jobs offshore since this enables them to avoid the job tax. The job tax problem stands to become larger as technologies for communication and control across long distances improves and trade in services increases. Eliminating the job tax can counter this trend by reducing the incentive to shift jobs. Moreover, U.S. firms that do transfer jobs offshore would implicitly end up subsidizing Social Security via the corporate income tax and via the personal income tax on dividends. Lastly, eliminating the employer contribution would lower costs of U.S. producers, thereby improving their competitive position vis-a-vis foreign rivals. This should be good for employment to the extent that it reduces imports and increases exports. All of these positive impacts on employment will contribute to higher market wages, as well as helping realize full employment and all the associated benefits that go with it.

VI Conclusion

Contrary to the claims of conservative critics, Social Security is affordable and its benefits are not excessive either in terms of amount paid or age of retirement. However, there are problems associated with its funding via the wage base. Funding a substantial portion of Social Security through general revenue would resolve these problems and bring a range of economic and policy benefits. It would encourage job creation, eliminate the deflationary bias inherent in the current system of partial pre-funding, enhance progressivity, and put a stop to the policy of using the regressive payroll tax to finance general government spending and tax cuts for the most affluent.

The current recessionary economic environment even offers an opportune moment to implement the above plan as it would increase most households' incomes, raise corporate profits, and lower employment costs. Lowering the employee contribution to 4% would provide a significant income boost to the vast bulk of households which stands to spur consumption spending.[13] Eliminating the employer contribution will raise corporate profits and cash flows, thereby combating the profits recession which is holding back investment spending.[14] And it will also lower the cost of employment, providing an incentive for firms to hire more workers. Finally, the reforms has a winning political construction in that the vast bulk of households benefit, as do small business and corporate America.

Are there any political down-sides to such a strategy. Yes, two. First, there is the danger that proposing systemic changes rather than marginal changes could open the door of a political process that gets co-opted by the interests of the privatizers. Second, there is a danger that making Social Security reliant on general revenue funding could make benefits more vulnerable to cuts should large budget deficits once again become part of the fiscal landscape. Regarding the first danger, letting policy be driven by the fear of co-option means that we settle for a distinct second best out of fear that a third best solution might be imposed. Yet, even then there is the danger that privatization could be imposed because there is a future funding shortfall and conservatives are using that shortfall to mislead the public that Social security is unaffordable. Regarding the second danger, even with pure payroll tax funding there is always the possibility that a conservative Congress might cut benefits. Indeed, the fact is that benefit cuts have already been enacted in the form of a higher future retirement age, and further benefit cuts are already being talked about within the parameters of the already extant debate.

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[13]. According to Citizens for Tax Justice, 80% of households had incomes below $72,000 in 2001. All of these households would therefore receive a payroll tax cut. 15% of households had incomes between $72,000 and $147,000. Many of these would receive a payroll tax cut, but those with incomes above $80,400 would now be assessed payroll tax at 4.2% on previously non-taxed income. Those with wage income below $118,600 would have a payroll tax cut, and those with wage income above would have a payroll tax increase. Against this, all households paying income taxes would pay more owing to higher income tax rates. The net effect of this tax reconfiguration would be to raise tax burdens on the top 10% of households ranked by income, and lower them on the bottom 90%. This will tend to increase consumption spending because lower income households have a higher marginal propensity to consume.

[14]. To the extent that firms use mark-up pricing there would be no long run impact on priftability. However, there would be a short run impact as costs would fall immediately and prices would come down thereafter. Moreover, lower prices would benefit consumers by raising the purchasing power of wages.

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	1960	2000	2075
Total dependency ratio	0.904	0.698	0.842
Aged dependency ratio	0.173	0.211	0.415

Table 1 U.S. dependency ratios for selected years. Total dependency ratio = population under 20 plus population over 65 divided by population aged 20 to 65. Aged dependency ratio = population over 65 divided by population aged 20 to 65 (Source: Social Security Trustees report, 2001, p.75).