SOCIAL SECURITY

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Dedication

To the thousands of activists, including many senior citizens, who have generously volunteered their time and energy to defending Social Security for future generations against an avalanche of misinformation, disinformation, and powerful political and financial interests. They will win.
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THE ONLY REASON TO CARE about economic policy is because it can be used to improve people's lives. Few policies have made as much difference in this regard as Social Security. It has allowed tens of millions of workers to enjoy a decent retirement over the last six decades, and it provides insurance against disability and early death. Social Security creates an element of security in an economic environment that fosters insecurity. For this reason, it deserves the enormous public support that it has consistently registered.

The Social Security system is currently threatened more than ever before in its 64-year history. The problem is not financial, economic, or demographic—the standard projections provide no basis for serious concern about the program’s financial survival. Nor is the problem a lack of political support for Social Security. This continues to be overwhelming. The problem is that people have become convinced that the program is in serious trouble. As a result of a steady stream of misinformation, the public could possibly allow a program that it values immensely to be seriously undermined or dismantled. Ironically, the greatest threat to Social Security has come from its would-be rescuers.

This book is written in the hope that the truth can make a difference. We believe that if people understand the basic facts surrounding the Social Security program, most of which are not in dispute, they will not tolerate its destruction. Some readers may reach different conclusions than we do about the merits of the current system, but it would be a tragedy if misinformation determined the outcome of the national debate.
Many people read and commented on all or part of this manuscript or earlier work from which it is derived. They include Eileen Appelbaum, Patricia Bauman, Jared Bernstein, Gary Burtless, Robert Haveman, Helene Jorgensen, Richard Leone, Robert Naiman, Joseph Quinn, Max Sawicky, John Schmitt, Joe White, and Howard Young. Special thanks are in order to Tammy Lyn Donohue, Joyce Kim, and Jon Schwarz, whose help with research was invaluable. The late Robert Eisner was tremendously helpful in developing many of the arguments presented here. He will be missed.
WE HAVE A CHANCE, said President Clinton, to “fix the roof while the sun is still shining.” He was talking about dealing with Social Security immediately, while the economy is growing and the federal budget is balanced. The audience was a regional conference on Social Security, in Kansas City, Missouri, that the White House had helped bring together.

The roof analogy is illuminating, but we can make it more accurate. Imagine that it’s not going to rain for more than 30 years. And the rain, when it does arrive (and it might not), will be pretty light. And imagine that the average household will have a lot more income for roof repair by the time the rain approaches.

Now add this: most of the people who say they want to fix the roof actually want to knock holes in it.

This is the situation facing Social Security, and it is well known to those who have looked at the numbers. The program will take in enough revenue to keep all of its promises for over 30 years, without any changes at all. Thirty years is a long time—it’s hard to think of any other program that can claim to be secure for that long. Furthermore, the forecast of a shortfall in 2034 is based on the economy limping along at less than a 1.7 percent annual rate of growth—about half the rate of the previous three decades.¹ If the economy were to grow at 1998’s rate, for example, the system would never run short of money.

¹. All numbers in this book pertaining to Social Security’s projected or current finances are, unless otherwise noted, taken from the 1999 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, published by the Social Security Administration.
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But even if the dismal growth forecasts turn out to be true, and the program eventually runs a deficit, it’s not exactly the end of the world. For one thing, the Social Security system would be far from “broke.” While it would indeed be short of revenue to maintain promised benefits, it would still be able to pay retirees higher real benefits than they are receiving today. And the nation has managed obligations of this size in the past: the financing gap would be roughly equal to the amount by which we increased military spending between 1976 and 1986 (a period in which we were not, incidentally, at war).

The program has promised, and historically delivered, a benefit that rises with wages in the economy. In order to maintain this commitment, we may have to increase the system’s revenues at some point. Would this place an undue burden on the post-2034 labor force? Hardly. Even if we were to increase payroll taxes to cover the shortfall, the added cost would barely dent the average real wage in 2034, which will be over 30 percent higher than it is today. It takes a great deal of imagination to perceive this as some sort of highway robbery by tomorrow’s senior citizens against the youth of today.

The simple truth is that our economy is generating more than enough income to provide a rising standard of living for future generations while meeting our commitments to Social Security. That’s true even at the terribly slow rates of growth projected for the future.

The strength of the economy isn’t perhaps as obvious as it should be, mainly because the majority of employees haven’t been sharing in the gains from economic growth. For more than 20 years, most wage and salary earners have actually seen a real decline in their pay (Mishel, Bernstein, and Schmitt 1999). So when people hear that future generations will be able to meet Social Security’s obligations out of a much higher income, they don’t believe it.

To reclaim the majority’s share of the economic pie is the real “challenge and opportunity of the twenty-first century,” to paraphrase another of President Clinton’s favorite lines. Yet the question of income distribution has been removed from the political agenda. Instead we are told that we can no longer afford our not-so-generous social safety net for the elderly. It is one of the greatest triumphs in the history of public relations to have transformed this prolonged episode of class warfare into an intergenerational conflict.

Mark Twain once said that a lie can get halfway around the world before the truth even gets its shoes on, and it’s hard to find a more compelling example than the lie about Social Security’s finances. Despite the fact that none of the numbers cited here are a matter of dispute, the public has been over-
whelmingly convinced that Social Security is in deep trouble. According to a February 1998 poll by Peter Hart Research, 60 percent of nonretired Americans expect Social Security to pay much lower benefits or no benefits at all when they retire. The proportion is even higher, at 72 percent, for people aged 18–34.

Ironically, the only real threat to Social Security comes not from any fiscal or demographic constraints but from the political assaults on the program by would-be “reformers.” If not for these attacks, the probability that Social Security “will not be there” when anyone who is alive today retires would be about the same as the odds that the U.S. government will not be there. The latter event is, of course, a possibility, but not enough of a likelihood that most people would plan their retirement around it.

Confusion over these issues is not confined to the general public: it has infiltrated the upper reaches of the economics profession as well. Lester Thurow is a former dean of MIT’s Sloan School of Management, arguably one of the nation’s best writers on economic topics. He is also to the left of most economists with regard to issues concerning the appropriate size and scope of government and its intervention in the economy. Yet in an essay in the New York Times Magazine, he argued that the nation’s growing elderly population constituted “a new...revolutionary class, one that is bringing down the social welfare state, destroying government finances, altering the distribution of purchasing power and threatening the investments that all societies need to make to have a successful future” (Thurow 1996).2

Even Paul Krugman, one of the nation’s foremost economists and winner of the John Bates Clark award (for the best economist under 40 years of age), fell victim to these popular notions of demographic determinism. In a favorable review of Peter G. Peterson’s latest book, Will America Grow Up Before It Grows Old?, he endorsed the volume’s thesis that major reform of the Social Security system was necessary to avoid an unresolvable budget

2. Among the misstatements that Thurow used to support his thesis was the assertion that “the current 15 percent Social Security tax rate would have to be boosted to 40 percent by 2029 to provide the benefits that have been promised.” The current tax for Social Security (including Survivors and Disability Insurance) is 12.4 percent of payroll (6.2 percent for both employer and employee). According to the best projections of the Social Security trustees, this tax rate is sufficient to pay full benefits through 2034; these benefits could be maintained for the next 75 years (through 2074) with a 2.07 percent payroll tax increase—about 1 percent each for employer and employee.
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crisis 20–30 years from now. "The budgetary effects of this demographic tidal wave are straightforward to compute, but so huge as to defy comprehension," he wrote (Krugman 1996a). Krugman later admitted, though, that he "went overboard in supporting Pete Peterson's position on entitlements and demographics... I broke my own rule that you should always check an argument both with a back-of-the-envelope calculation and by consulting with the real experts, no matter how plausible and reasonable its author sounds" (Krugman 1996b).

Both Krugman and Thurow fell for the "entitlements trick," a device deployed with great success by advocacy groups like Peterson's Concord Coalition. The idea is to lump Social Security and Medicare together as "entitlements for the elderly." On the basis of the last 30 years of health care inflation, it is easy to project explosive growth in future Medicare spending. The federal budget deficit therefore also explodes, and the whole economy goes down the tubes.

But Social Security and Medicare are separate programs, funded by separate taxes. There is a connection in that Medicare's Part A, which covers hospital insurance, was modeled after Social Security in the sense that it is a social insurance program for the elderly. Most people probably do not distinguish between the part of their payroll tax that goes to Social Security and the part that goes to Medicare. As a political matter, for example, a large increase in the payroll tax for one program would make people less willing to pay more for the other.

But the two programs are financed separately, and they face very different financial problems, with different causes. Although Social Security is not facing any serious financial difficulties, Medicare will run into serious trouble within the next decade if medical care inflation continues at its historic rates.

Because the fees paid by Medicare to health care providers are overwhelmingly determined in the private health care system, Medicare's financial problems have been driven by decades of double-digit inflation in the private sector. The program could be abolished entirely, but that would not avert the economic disaster 35 years from now that emerges from a simple projection of past increases in health care spending into the future. In short, past rates of increase in health care spending are economically unsustainable, regardless of what happens to Medicare (see chapter 3). These projections make a good argument for health care reform, but they say little about "entitlements for the elderly," and nothing at all about Social Security.
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The generational warriors have shunted aside these basic facts, preferring instead to view Medicare’s real financing problems, like Social Security’s imagined problems, through a fantastic prism of demographic determinism. Peter Peterson conjures up frightening dystopian visions of “a nation of Floridas” (Peterson 1996), with hordes of gray-haired baby boomers jetting around the country on senior citizen travel discounts, laying waste to the potential savings of Generations X, Y, and Z. The media have been influenced by these warnings, and we are regularly informed, as in the New York Times, that “Social Security faces a crisis early next century when the 76 million in the baby boom generation start retiring and putting a strain on the system” (Mitchell 1998).

But the baby boomers begin retiring in 2008, and at that time Social Security will still be running an annual surplus of about $150 billion (in constant 1999 dollars) per year. In fact the last of the baby boomers will already be retired by the time the system suffers its projected shortfall, even assuming the slow growth described above, at the end of 2034. It may come as a surprise to many readers that the main reason for this projected shortfall in the second half of the 75-year planning period is not the retirement of the baby boom generation. Actuarially, the main reason is that people are living longer.

Another example of how the truth of these matters can be so easily turned upside down is the belief of millions of people that Social Security has actually contributed to the federal budget deficits and the national debt. In fact the opposite is true: the Social Security trust fund loans its annual surplus, now running at over $124 billion, to the federal government. The surplus, which has been accumulating since 1983, when the payroll tax was increased, will help finance the baby boomers’ retirement, which is why the program will not have any trouble meeting its obligations while the boomers are retiring.

So much for the “demographic time bomb” with which the system’s “reformers” have been threatening us. With a few selected facts dressed up as surprises—such as a rising elderly population or a declining ratio of workers to retirees—and an oversized dose of verbal and accounting trickery, opponents of Social Security have been able to create the impression that the program is demographically unsustainable. This impression is false, as would be any economic projections that failed to take into account the other side of the equation, namely, the growth of the economy (see chapter 1).
Even the financial problems of Medicare do not result, for the most part, from demographic changes. While it is true that older people, on average, require more health care than the young, overall health care spending, as a percentage of gross domestic product, does not necessarily have to increase with the average age of the population. In fact, among most developed countries there appears to be no correlation between health care spending and the percentage of the population that is over 65. As a percentage of our economy, we spend twice as much on health care as does Sweden, for example, yet 17.3 percent of Sweden’s population is over 65, a proportion we will not reach for another 25 years (see chapter 3).

Rather, the financial threat to Medicare arises as this relatively more efficient system—its administrative costs are less than one-fourth those of the private system—is subjected to increasing “marketization.” The number of senior citizens who get their Medicare coverage through health maintenance organizations (HMOs) more than tripled from 1992 to 1998 and has been growing at a rate of 25 percent per year. It doesn’t take a financial genius at an HMO to figure out how to profit in this market. With about 90 percent of senior citizens costing Medicare an average of only $1,200 each, and with the government paying HMOs up to $6,000 per person, depending on the region, managed-care providers have been able to profit enormously by selecting, as much as possible, the healthiest senior citizens and leaving the rest (the least healthy 10 percent cost about $37,000 each) in the hands of Medicare. It all works out quite nicely for the HMOs, who can point to rising costs for Medicare relative to the more “efficient” private sector. Never mind that the HMOs’ cost reductions are achieved not only through selection of healthier patients—wasting even more resources in the selection process—but also by cutting back on necessary medical procedures. The prejudice in favor of market-based solutions is so powerful that even the groundswell of consumer dissatisfaction has yet to force policymakers to reexamine it.

In the last few years, the spread of managed care has created the illusion of efficiency in the private sector by reducing private medical inflation to more manageable levels. It remains to be seen whether these lower levels of price increases can be sustained, particularly without further cuts in necessary medical services.3 In the meantime, the call for real health care reform

3. Health insurance premiums are expected to increase by approximately 7 percent in 1999, as compared to overall inflation running at about 2.2 percent.
has been muted, and the country has been moving in the opposite direction from where it needs to go. While HMOs soak Medicare for its profitable patients and services, cuts are proposed to bring the program closer to fiscal balance. And recent legislation has opened the door to further fragmentation of the risk pool by allocating $2.2 billion to create "medical savings accounts." These would allow the healthiest among senior citizens to gamble that their health care expenses will be less than average and to keep some of the difference if they win.

Privatization fever has now spread to Social Security, fueled by the fastest run-up in stock prices in U.S. economic history. Advocates have crafted their appeal to the growing segment of the public that has at least some money invested in stocks, mostly in 401(k) retirement plans. This is still a minority of the population—about 41 percent of households at latest count. And ownership is highly concentrated: the typical stock-owning household has only about $14,000, with millions holding only a very small proportion of their assets in stocks. At the other end of the distribution, about 5 percent of households hold the majority of stocks.

Nonetheless, there has been a rapid expansion in stock ownership, primarily through stock mutual funds, over the last decade. This growth has created a base of support for the idea that people could be better off if their Social Security payroll taxes were invested privately. According to various popular presentations of this idea, everyone could be a millionaire upon retirement.

And indeed they could, if stocks were to continue to double every three years. But there are limits to such speculative bubbles. The reality is that the very run-up in stock values that has placed privatization on the political agenda makes even the relatively modest returns of previous decades less likely in future years. Furthermore, due partly to a slowing of population growth and partly to a (largely unexplained) slowdown in the growth of productivity, the economy is not projected to grow as fast as it did previously. But neither the privatizers nor even the actuaries who made the projections for the recent Advisory Council on Social Security have taken these facts into account when projecting the rate of return for equities. This omission is strange, because it is only under the conditions of the very slow growth forecast that there is

4. Much more important than the bull market have been the longer-term political and ideological changes that have set the stage for the pro-privatization effort (see below).
even a small projected shortfall in Social Security’s revenues. But if the economy is going to grow at less than half the rate of the past 75 years, as the Social Security trustees predict, then the return on equities cannot maintain its past performance.

Over the past 75 years, the stock market has averaged a real (after-inflation) annual return of 7 percent. This is a healthy rate, which would double an investor’s money about every 10 years. Privatizers argue that the extra risks of the market smooth out over a long period of time, making the market the best place for retirement savings. And they complain that employees whose savings are primarily diverted to Social Security are unfairly prevented from cashing in on these higher returns. During the stock market’s turbulence in 1997 and again in 1998, millions of small investors showed their faith in these arguments by buying during the dips and pushing the market back up. “I’m in it for the long haul” was a typical response by mutual fund owners to the market’s wild ride.

But it is precisely the long haul that one can actually say something about. In the short run, all kinds of speculative bubbles are possible. Psychological factors—most obviously, the expectation of either higher earnings in the future or simply higher stock prices—can drive the stock market to seemingly unlimited heights. But over a long period of time—certainly well within the enormously long 75-year planning horizon for the Social Security system—the price of stocks is limited by the earnings of their underlying assets. That is, stocks are ultimately valuable because the companies they represent earn profits. These profits either are distributed to shareholders in the form of dividends or, if reinvested in the company, form the basis for shareholders’ capital gains.

In the short run, there is no necessary relation between the price of stock shares and a company’s profits: investors will continue buying so long as they think the price will be higher next year. And it will be higher as long as enough people believe that it will. But this process has an upper limit, as the Japanese learned all too well in 1990. At that time the Nikkei index of Japanese stocks had reached 38,712; it now stands below 14,000.

No one can safely predict when the stock market will reach its upper limit—anyone with such forecasting acumen could get rich overnight. But there are certain things we can pretty much rule out when we look at a long enough period of time. For example, the price-to-earnings ratios of stocks in the United States are now at near-record levels of 33 to 1. If prices continue to
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rise faster than profits, this ratio could go higher still. But would investors still hold stocks if it reached 234 to 1? It strains the imagination that they would, yet these are in fact the consequences of assuming that the market will continue to provide a 7 percent return. As noted above, returns on stocks depend on profits, and the growth of profits is proportional to the growth of the economy. If the economy grows at half its past rate, which is the assumption underlying the dire Social Security forecasts, then profits cannot grow as fast as they used to. And so, if we are to accept the projections of a 7 percent rate of return, we must also believe that the price of stocks will rise meteorically in relation to earnings. The arithmetic tells us that we would see a price-to-earnings ratio of 234 to 1 by 2055.

Undoubtedly the bubble would burst long before the price of stocks flew this far away from the earnings potential of the stocks' underlying assets. So we can safely conclude that the forecast of the privatizers (and of the Advisory Council on Social Security) of a 7 percent real rate of return on equities is, for all practical purposes, impossible. It turns out that the rate of return that is compatible with their projected economic growth is about 3.5 percent. Then there are the quite substantial costs of administration and brokerage fees that the current system avoids but that a private system couldn't. Adding these in knocks the return to privatized accounts down another percentage point, to 2.5 percent (see chapter 5).

And this is still a very charitable evaluation of privatization. Its advocates would like to maintain the mandatory character of Social Security while channeling this money into private accounts. They could hardly choose otherwise. Most households have not taken advantage of existing tax breaks for private savings. According to the most recent data available, of the 70.5 million workers with annual incomes under $30,000 in 1993, only 5.4 percent put money in an individual retirement account. Forcing people to save and invest their money in privatized accounts raises a host of interesting but not easily resolvable problems. The government will have to certify certain mutual funds for participation in this system. It will have to protect against fraud and other forms of abuse. There will be a lot of political pressure to bail out funds that go bankrupt. And will the government prevent people from borrowing against their forced savings? How will it enforce the conversion of these savings into a stream of retirement income?

Even if all these problems could be resolved at reasonable expense, and without creating an enormous, hateful bureaucracy, the big question remains:
what to do about all the people who have been promised Social Security payments over the next four decades? That's how long it will take for the first cohort of private Social Security investors to be able to retire on the returns from their individual accounts. In the meantime, while investors' money is going into these private accounts, the system cannot do much for the tens of millions of beneficiaries whose checks are due. That means a major tax increase, enough to guarantee a negative return for the first generations of privatized savers.

A number of other dubious arguments advanced in favor of privatization are addressed in chapter 5. These arguments have been put forward with increasing urgency as the privatizers struggle to achieve their goals before the public discovers that stock prices can go down as well as up.

Other "fixes" are on the table as well, all of which would cause enormous casualties among the elderly. For example, many people would like to raise the normal retirement age. The idea might seem reasonable enough at first glance, since average life expectancy is increasing each decade. But consider what it means in light of the vast discrepancies in life expectancy among demographic groups. A typical black male worker who is 39 years old today can expect about 2.3 years of full retirement benefits, compared with 8.4 years for his white counterpart. Do we really want to drastically worsen that ratio by taking a year or more away from each?

Differences in life expectancy along class lines—income, occupation, and education—are about as big as the disparity by race. Raising the retirement age is therefore one of the most regressive ways to cut Social Security spending. It is analogous, in the realm of tax policy, to a per capita income tax increase. In other words, one could make the argument that since per capita income is growing every year, why not just increase everyone's tax bill by $1,000, regardless of his or her income or wealth? Such a proposal would never get serious consideration—it is much too regressive even for the advocates of a "flat tax" and similar schemes—yet this is essentially what we do through the Social Security system when we raise the retirement age among a population in which there is such a great disparity of retirement years.

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5. The normal retirement age is the age at which people can retire with full benefits. It is currently 65 and will begin rising in the year 2000, reaching 67 for workers who retire in 2017. However, a majority of workers opt for early retirement, with a reduced benefit, at ages 62–64.
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Other proposed fixes are similarly regressive, and unjustifiable on economic grounds, yet they seem to get serious attention. One of the more prominent of these (discussed in chapter 4) is the proposal to cut the Social Security cost-of-living adjustment (COLA), under the assumption that the consumer price index (CPI), on which COLAs are based, overstates the true rate of inflation (see Baker 1997). A panel of economists was appointed by the Senate in 1995 for the purpose of determining how much the CPI overstates inflation. The Boskin Commission, chaired by President Bush’s former chief economist, Michael Boskin, decided that the CPI was off by 1.1 percentage points. This meant, or at least it was hoped, that Social Security’s COLA could be cut by that amount. That may not sound like a lot, but if this conclusion had been adopted in 1998, the average beneficiary would have lost about $1,500 over the following five years.

Since America’s poorest seniors rely the most heavily on Social Security, such changes would cause a significant increase in poverty among the elderly. If this change had been made 10 years ago, there would be at least 600,000 more senior citizens in poverty now than there are currently (Weisbrot 1997, 20–21).

Supporters would like to dress these measures up in a white coat of “technical expertise,” but that coat looks rather shabby on closer inspection. The most serious problem is that adopting the Boskin Commission’s estimate of inflation would require us to radically change our view of the economy. For example, if we have been overstating inflation by as much as the commission claims, then real income has been growing a lot faster than we thought—so fast, in fact, that most Americans must have been living near or below the poverty level in 1960 (a year in which 57 percent of households owned their own homes and 76 percent had cars). Furthermore, the whole history of declining real wages for the majority of workers over the last two decades will also need to be rewritten—conveniently for some—as an illusion.

Looking toward the future, we get even more interesting results if we accept the commission’s estimate. It means not only that we have underestimated real wage growth in the past but that we are similarly off the mark in forecasting the future. The Boskin future is so bright that the typical wage earner will be hauling in more than $50,000 a year in real (inflation-adjusted) income by 2030, or about twice the typical wage in 1995. The irony of this effort to redo the CPI is that, if its proponents are correct, their rationale for cutting Social Security benefits disappears. We would be cutting benefits for
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those who spent most of their lives in poverty in order to maintain lower taxes on generations who will have, by even today’s standards, quite healthy incomes. Even the most shameless granny-bashers should have a hard time justifying this kind of redistribution.

Other numbers in the Boskin report don’t make much sense either. To take just one example: the commission argues that the CPI doesn’t adequately take into account quality improvements, such as better gas mileage or the installation of air bags in cars. But the Bureau of Labor Statistics (BLS) makes extensive adjustments for quality. In 1995, the CPI rose 1.8 percent; without the quality adjustments made by the BLS, it would have risen 4.0 percent. This is a large adjustment, but the Boskin Commission, without conducting any original research on the subject, asserts that this is not enough. Their arguments are not convincing. In the case of cars, the BLS asks auto companies how much of their price increases are due to quality improvements. It is hard to imagine that these companies would respond with severe understatement.

The Boskin Commission was stacked with five economists who had previously proclaimed their belief that the CPI seriously overstates inflation. They looked for everything that might support this conclusion while overlooking evidence and arguments that pointed in the opposite direction. The scenario is a sad illustration of what happens when those pursuing a political agenda—in this case the Senate Finance Committee—attempt to corrupt the process of estimating fundamental economic statistics.

Congress has thus far failed to incorporate the Boskin changes, but the issue is far from settled. Indeed, one of the more prominent Social Security “reform” proposals on the table right now, put forth by Senator Daniel Patrick Moynihan, contains a COLA cut.

Social Security and Social Insurance

Social Security is our largest and most successful antipoverty program, keeping about half of the nation’s senior citizens from falling below the official poverty line (SSA 1998b). In 1959, the poverty rate among the elderly was more than 35 percent; by 1970, it was twice the rate of that for the general population. Largely as a result of the Social Security program, it has since fallen to 10.8 percent, or slightly less than that for the general population (SSA 1997). For two-thirds of the elderly, Social Security makes up the majority of their income; for the poorest 16 percent, it is their only source of income (SSA 1998b).
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Social Security provides about $12 trillion worth of life insurance, more than that provided by the entire private life insurance industry (Ball et al. 1997, 32). The program’s 44 million beneficiaries today include 7 million survivors of deceased workers, about 1.4 million of whom are children (SSA 1998a, 1). Some 5.5 million people receive disability benefits, including not only disabled workers but also their dependents. For a typical employee, the value of the insurance provided by the program would be more than $200,000 for disability and about $300,000 for survivors insurance (Ball et al. 1997, 32).

The coverage of the program is nearly universal—about 95 percent of senior citizens either are receiving benefits or will be eligible to receive them upon retirement (Advisory Council 1997, 88). For a society that wants to ensure some minimum standard of living for its elderly, this is an important achievement in itself. But it also allows for other accomplishments that would be difficult or impossible to replicate in the private sector. For example, Social Security provides an inflation-proof, guaranteed annuity from the time of retirement for the rest of the beneficiary’s life. The cost of retirement, survivors, and disability insurance does not depend on the individual’s health or other risk factors. And the benefits are portable from job to job, unlike many employer-sponsored pension plans.

The success of Social Security also owes much to the superior economic efficiency of social insurance as a means of providing core retirement income. The program’s administrative costs are a small fraction of the private alternatives: they amount to less than 1 percent of payout (SSA 1996a), as opposed to 12–14 percent for the private life insurance industry.6 On these strictly economic grounds alone, the case for Social Security is strong.

But social insurance also embodies a different ethic and a different conception of the relation between the individual and society. The ethic is a solidaristic one, which is different from either self-interest or altruism. It transcends this dichotomy in favor of a collective self-interest that promotes the advancement of everyone.

Most of us will grow old and will, either before or during that time, experience health problems or reduced capacity for work. The ethic of social insurance says that “we are all in this together” and that it is in our collective and individual interest to pitch in and provide for these eventualities and risks. We can contribute when we are relatively young, healthy, and working,

6. Based on data from the American Council of Life Insurance.
and draw benefits when we are not. Some will draw a luckier number in the
genetic lottery or inherit wealth or even be more successful or healthy or live
longer by virtue of their own efforts or wisdom; but this is no reason to deny
the necessities of life to anyone else, any more than we would want our local
fire department to ignore calls from the poor, or even from those whose fires
were caused by their own carelessness.

The case for social insurance is also grounded in a view of society that
differs considerably from the agglomeration of atomized individuals, each
maximizing his or her own utility, that forms the foundation of contemporary
neoclassical microeconomics. In this broader context, the national product is
seen more as a social product, which requires the efforts and cooperation of
all who work. Market outcomes are not necessarily fair or just, nor should
they determine one’s fate, especially in times of hardship.

Despite the political resurgence of a market-driven ethic in the last two
decades, the majority sentiment is probably still closer to the solidaristic ethic
embodied in the principles of social insurance. At the very least, this is true
for the areas that social insurance has typically covered: protection against the
reduced earnings potential and hardships of old age, sickness, disability, and
unemployment.

Social insurance has also succeeded in avoiding the stigma and political
weaknesses from which means-tested welfare programs have suffered. These
weaknesses have been increasingly exploited by politicians since the 1980s,
culminating in the elimination of Aid to Families With Dependent Children
(AFDC) in 1996. Programs like Social Security and Medicare have been pro-
tected from these types of divisive attacks, largely due to their universal cov-
ervation and work-based entitlement.

Social Security has also become increasingly important in light of what
has happened to the other two major sources of retirement income: private
savings and employer-sponsored pension plans. The regressive changes in
income distribution that have taken place over the last two decades have made
it increasingly difficult for most people to save for their own retirement. The
median wage actually fell 6.8 percent from 1973 to 1997, and declines have
been much worse for those with less education. This is a drastic change from
the previous era, from 1947 to 1973, when the typical wage earner saw real
gains on the order of 79 percent (Mishel, Bernstein, and Schmitt 1997, 140–
43; 1999, 131).

At the same time, private pensions have shifted from defined-benefit plans
to defined-contribution plans. In a defined-benefit plan, the employer assumes the risk associated with the return on accumulated pension funds by guaranteeing a specified benefit upon retirement. In defined-contribution plans, such as 401(k) plans, which allow employees to defer compensation tax-free into retirement accounts, the employee assumes the risk. In the past, defined-benefit plans were the norm: 94 percent of those receiving private pension benefits today receive them through defined-benefit plans. But today more employees participate in defined-contribution plans than in defined-benefit plans. Together with the difficulty of saving for retirement out of declining real wages, these trends have made Social Security the one part of retirement income that the majority of Americans can really count on.

All of this makes a strong case for expanding, rather than shrinking, social insurance, especially if we want to counter the now decades-old trends toward increasing inequality and poverty in the United States. As noted in chapter 3, the health care system would be a logical next step in such an expansion. Medicare was an attempt to extend the principles of social insurance to health care, but only partially, since the elderly are still segmented from the rest of the population. Insurance involves the pooling of risk, and from an economic standpoint the most efficient way to do this is to put everyone in one large risk pool. Together with the enormous economies of scale in administration, this is the basis for the superior efficiency of social insurance.

Although Medicare has succeeded in providing access to health care for millions of older Americans and in reducing administrative costs relative to private insurance, it has not been able to contain the explosive medical price pressures that have been generated by the private sector. The rational solution would seem to be to extend social insurance for health care to the rest of the population, thereby eliminating enormous amounts of waste and placing global controls on overall spending. The administrative savings alone, according to some estimates, would be enough to provide health care coverage to the 43 million Americans who are currently uninsured. But it will be difficult to have an informed public debate about the expansion of social insurance as long as widespread misconceptions prevail about our existing programs of Social Security and Medicare.
Introduction

The Politics of Non-issues

As will be seen throughout this book, the numerous cuts proposed to “fix” Social Security are neither just nor justifiable, nor are they necessary. The system’s financing problems are still very much in the distant future. Should they materialize, they would be quite small relative to the nation’s future income.

How is it that a sense of urgency has been created around such a small, far-off, nonproblem? Multiple causes have led to this strange result, ranging from the crass commercial interests of Wall Street, to more general political trends, to recent changes in the esoteric world of economic theory.

There is no doubt that Wall Street has an enormous direct stake in any kind of privatization of Social Security, and it has been investing in the production of ideas necessary to bring this transition about. “You could be staring at 130 million new accounts,” said William Shipman of State Street Global Advisors, a division of State Street Bank, which has contributed tens of thousands of dollars to various research institutes to study privatization. One-quarter of the Cato Institute’s $2 million Project on Social Security Privatization has come from Wall Street firms (Lieberman 1997).

But the potential windfall of a privatized system is only part of the financiers’ interest in the reform of Social Security. The big bondholders have a financial stake in anything that reduces federal spending or, for that matter, growth and employment generally. They have only one enemy: inflation. And like those who suffer from obsessive-compulsive disorder, they see pitfalls and dangers where others see only the normal vicissitudes of everyday life, or even progress: in lower unemployment rates, rising wages, and, for the longer term, a rising share of national income devoted to federal entitlements.

The bondholders’ perspective has been so thoroughly assimilated that much of current policy discussion implicitly assumes that what’s good for the bond market is good for the economy, even when that means higher unemployment and slower growth. Thus we are regularly informed in the business press that the Federal Reserve Board “will have to raise interest rates” if wages continue rising (Stevenson 1998c), even at the rate of productivity growth, as if there were no choices that would allow the majority of wage earners to get a proportionate share of the gains from an expanding economy.

The attention that has been devoted in recent years to the problem of balancing the federal budget provides another example of the triumph of ide-
ology over economic reasoning. It is also a good illustration of how the politics of non-issues has come to dominate civil society in the United States. Here is an economic policy that, even if we grant all the dubious assumptions of its proponents (for example, that the economy normally runs at full employment) can only be regarded as trivial in its effects. Just look at the difference between running a budget deficit of 2.5 percent of gross domestic product (GDP)—more than $200 billion in today's economy—versus balancing the budget every year from 1996 until 2030. According to the Congressional Budget Office, the best that balancing the budget could do for us would be to give us the output of goods and services in 2030 that we would not otherwise have until 2031. As a best-case scenario, it's not much to write home about.

To illustrate the relative insignificance of the economic impact of balancing the budget, consider the impact of past and current trends toward increasing inequality in the distribution of income. If these trends continue to 2030, they will cost the typical family about 25 percent of its income. Yet no legislative agenda, constitutional amendment, or campaign for high office has been centered on this very real and continuing threat to the well-being of future generations. Instead we have been treated to the dire premonitions of the generational warriors, who fortunately remain, at this writing, generals without an army. Nonetheless, they have managed to exert more influence than those who are concerned about more contemporary issues such as poverty and inequality. Their vehicles have included the academic writings of respected economists (see chapter 2), as well as popular writings and organizations such as Economic Security 2000, the Concord Coalition, and the Third Millennium. Through these efforts they have added their own special contribution to the litany of demographic determinism that has muddled the debate over entitlements for the elderly. That contribution has been to characterize the national debt as an unjust burden passed on to future generations, who will have to pay for our high living with a lifetime tax burden that will devour most of their hard-earned income.

The first part of the argument is based on a logical error: it is impossible for the present generation to “burden” future generations with a national debt. Any debt owed by future generations will also be owed to future generations, because each generation that pays interest on the national debt pays

7. The exception to this generalization would be if current borrowing drove up interest rates enough to “crowd out” a large amount of private investment, thus leaving future
that money to members of the same generation who own the Treasury bonds. So the national debt, however much one may dislike it for aesthetic or other reasons, cannot be used as an instrument to redistribute income between generations.

The economists among the generational warriors will admit this if pressed (they do, after all, teach introductory economics courses) and retreat to other arguments. These arguments have been refined into a system of “generational accounting” that purports to show lifetime net tax rates averaging more than 80 percent for all future generations. However, as shown in chapter 2, some very special assumptions are required in order to reach this terrifying conclusion. One of those we have already seen: that public sector health care costs continue to rise without containment, based on past rates of increase. As noted above, such explosive rates of increase would wreak havoc by the middle of the next century, regardless of whether the government attempts to maintain its Medicare and Medicaid programs for the elderly and the poor. Such projections tell us less about questions of intergenerational equity than they do about the value of making projections based on unsustainable trends. If this is what we want to do for entertainment, we could forecast that more than a quarter of all American adults will be incarcerated, on parole, or on probation by 2045, based on past rates of increase in the number of people convicted of crimes.

It may seem strange that anyone would project such explosive health care costs into the indefinite future and focus only on the implications for people’s tax burdens, but some of the other assumptions of generational accounting—such as unusually large discounting of future income, and treating education as a cost with no benefits—make even less economic or logical sense. When all of these assumptions are restored to normalcy, the whole nightmarish tax burden dreamed up by the generational accountants disappears (see chapter 2).

How can we explain the predominance of non-issues like the national debt, the federal budget deficit, generational accounting, and the Social Security “crisis,” which cannot withstand the most minimal scrutiny through the lens of logic or empirical evidence? Part of the problem lies deep within our political system, and especially its corruption in the financing of election generations with a much reduced capital stock. However, as noted above, the potential “crowding-out” effects of government borrowing turn out to be very small.
campaigns. In such a system it becomes nearly impossible for politicians to attack more real and urgent problems such as poverty and inequality. Those who attempt to do so soon discover that they cannot raise the ever-increasing amounts of money needed to make a serious bid for political office. At the same time we have experienced a major shift in the parameters of policy analysis, fallout from the years of antigovernment rhetoric and ideology of the Reagan era. Many of the core elements of this shift have been accepted by liberals and conservatives alike. The idea that the government cannot do anything right, or at least not as efficiently as the private sector, has become a truism.

All of these developments have thrust this particular set of non-issues into a prominent place in American politics. They have also found a more hospitable environment than they would have encountered 25 years ago, thanks to certain changes in the mainstream of economic theory. Central to the current debate is the idea that Americans are not saving enough and that this is a major cause of our economic problems. For example, the steep decline in the rate of growth of productivity—and hence in the growth of our economy and wages—is often attributed to a shortage of savings. This leads, according to the now conventional wisdom, to a lower rate of investment and therefore growth.

But this chain of causality running from savings behavior to investment to growth, which dominated economic theory prior to John Maynard Keynes and the Great Depression, has been rehabilitated only relatively recently. As explained in chapter 7, it is also possible to view the causality in the opposite direction: lower levels of investment result in lower productivity growth, which reduces the rate of growth of income. Savings rates then fall as a consequence, rather than a cause, of slower income growth. This view, which also relies on the more plausible assumption that our economy is not generally at full employment, was the predominant view among economists until about 25 years ago. The reincarnation of nineteenth-century macroeconomics in academia over the last couple of decades has done much to give these “shortage of savings” arguments a new lease on life. However, as noted above, even within the framework of such theories, increasing the savings rate by any amount that is within the realm of possibility would have almost no noticeable effect on growth. But that has not stopped the popularizers of Social Security and budget “reform” from drawing momentous conclusions. “To avoid steep economic decline,” warns the Concord Coalition’s Peter Peterson, “we must forsake
Introduction

our consumption and deficit habits and once again reshape ourselves as a savings-and-investment society" (Peterson 1996, 17).

This is a simple and attractive explanation for declining living standards. It appeals to traditional values of hard work, self-sacrifice, and thrift. Peterson likes to talk about his Greek immigrant parents, who arrived here penniless, operated a small restaurant that was open 24 hours a day, 365 days a year, and saved every nickel they could. There is also a significant and growing sector of the population that believes that Americans consume too much. The reasons range from considerations of environmental sustainability to the sense that spending habits are forcing people to work many more hours than is necessary or desirable. Although these concerns do not necessarily overlap with the question of savings (we could, for example, reduce the workweek or the environmental “throughput” involved in consumption), they have made it easier to sell people on the idea that Americans should save more. Privatizers have added yet another layer of confusion by pretending that a system of personal retirement accounts would somehow increase the national savings rate. To the extent that taxes would have to be increased to pay for the transition, this would be true by definition. But that is not what they are saying, since they are not openly advocating increasing national savings by increasing taxes.

The current preoccupation with these non-issues is a transitory phenomenon. Like other intellectual fads it will spend its hour on the stage and then fade, freeing policymakers, politicians, think tanks, and journalists to turn their attention to more important concerns. In 1960 the poverty rate for American children was 27 percent. It fell to 14 percent in 1973, but by 1993 it was back up to 23 percent, eliminating most of the gains of the War on Poverty. Forty-three million people are without health insurance, and the numbers are still growing. Our educational system is failing to provide millions of children with even basic reading skills. And even middle-class families are struggling to put their children through college.

It is well within our means to solve these problems. In fact, most of them do not exist at anywhere near the same level in other industrialized countries of comparable income. Perhaps we should put these more pressing problems first on the agenda, and leave the phony crises for later.

8. In a 1995 poll by the Merck Family Fund, 82 percent of respondents acknowledged that “most of us buy and consume far more than we need” (Merck Family Fund 1995).
HERE IS AN OLD RIDDLE that illustrates the kind of verbal and accounting trickery that has been used to create the illusion of a Social Security crisis. It goes like this: A man walks into a hotel and gives the clerk $30 for a room. The room costs $25, but the man takes off to his room without the change. The clerk summons an employee, gives him $5, and tells him to take it up to the guy's room. On the way up in the elevator, the employee decides to take $2, figuring he can tell the customer that the room costs $27. He gives the customer $3 and heads off to buy a drink.

Here's the punch line that has confused (at least temporarily) generations of listeners: the customer paid $27, the employee took $2—that adds up to $29. What happened to the last dollar?

Of course there is no missing dollar. The riddle is designed to make the listener think that there is a dollar missing by posing a question that at first glance appears to be part of a logical accounting framework. But in fact it is not.

It may seem incredible that the widespread belief in Social Security’s "looming insolvency" has been generated by this kind of sleight of hand, but that is more or less the case. With enough money and power behind them, all sorts of ideas can find themselves promoted to the status of conventional wisdom—we should be thankful that no moneymed interests have yet thrown their weight into the search for the missing dollar. As for Social Security, the best way to sort out the truth of the matter is to look at the actual state of the system's finances, including projections into the future, and then see how the system's opponents (and "reformers") have misrepresented this picture.
Chapter One

Social Security's Finances

It is important to understand that the debate over the state of Social Security's finances is not an argument about what kind of economic assumptions to make about the future. That is, the most prominent voices on all sides of the issue—even those arguing for severe benefit cuts or privatization—are operating from the same set of economic and demographic assumptions about what will happen over the next 75 years. This may seem strange, because even relatively small changes in such variables as productivity or population growth, wage growth, and others can have a large effect on the projected balance sheet a few decades from now. But Social Security's critics have not seen fit to challenge the projections that are put together by the actuaries at the Social Security Administration. (These are updated and published each year in the annual report of the Board of Trustees of the Social Security trust fund.)

The trustees' report contains three sets of projections: a high-cost, intermediate-cost, and low-cost scenario. The intermediate projections—considered by the trustees to be their best estimates—are generally accepted as common ground in policy circles. When one looks at the assumptions, it is easy to see why even Social Security's most fervent opponents rarely try to make the case for anything worse.

The trustees' intermediate projections are based on a slow-growing economy, in fact worse than any previous period in American economic history. The economy is projected to grow at just under 1.5% per year over the 75-year planning horizon, far below the 3.0% growth rate of the last 75 years.

Even under these pessimistic assumptions, the Social Security system, without changing anything in the tax or benefit payout structure, will meet its obligations for the next 35 years. During this time the entire baby boom generation will retire, beginning with early retirees (at age 62) in the year 2008. Table 1-1 shows the projected number of beneficiaries over the trustees' planning period. The retirement of the baby boom generation can be seen in the sharp increase between 2010 and 2030, from 44.3 million to 70 million, or 58%. The two decades after that, by comparison, show only an 8.5% increase. But the retirement of the baby boomers has already been taken into account, and so the program will not have any trouble accommodating the flood of retirees during the 2010–30 period (as discussed below). This is in sharp contrast to widely held beliefs that the retirement of the baby boom generation will bankrupt Social Security.
The high level of financial security that the system now enjoys is not well appreciated. In 1983, the Social Security trust fund was within a few months of falling short on its obligations to beneficiaries. Of course no one came close to missing a check, and it is doubtful that the federal government would ever default on its obligations to beneficiaries simply because of a shortfall in the program’s revenues. But in any case we are at least 35 years away from reaching the situation that we faced in 1983.

Few programs even a fraction of this size, public or private, can claim to be fully funded for more than the next three decades. That ought to be the end of the story—we have plenty of time to “fix” Social Security if it looks like it will run into trouble further up the road. But there are two main reasons why the story does not end here. The first is legal and technical: the trustees are required to show that the system is “in actuarial balance” for the next 75 years. As a practical matter, projections that far into the future are little more than fortune-telling. Think of the world in 1924—what possible conception of today’s economy would anyone have had back then? Computers, air travel, mass electronic media, and popular ownership of cars had yet to enter the equation, not to mention the Great Depression and another world
war. It strains credibility to imagine that we have any better idea what the world is going to look like 75 years from today. Nonetheless, that is the current law, and so the debate over Social Security is embedded in a 75-year planning period.

The second reason that three decades of solvency are not treated as well as they should be is political. In a climate of suspicion toward government programs in general, and with all the hype about entitlements, it is easy to find a credulous audience that will take 75-year projections seriously, especially if the projections show a shortfall, as they do, between year 35 and year 75. Yet even that shortfall, which may never materialize, is hardly anything to worry about. If we were to ignore the problem completely for the next 13 years and then fix it by the most politically drastic means—raising the payroll tax—future generations would not be greatly burdened. For example, an increase in the payroll tax of one-tenth of 1 percent each year (split between employer and employee), beginning in 2011 and continuing until 2046, would close the gap. This would still leave future generations with an after-tax wage far higher than that of today’s employees. For example, the average employee in 2030 would have an after-tax wage that is 28.7 percent higher than today, in real (inflation-adjusted) terms. Without these payroll tax increases, that employee would have an average wage 30.7 percent higher than his or her counterpart of today. This is real, after-tax income, and it will be earned after the entire baby boom generation retires, with no cuts in benefits. This is hardly the stuff with which to send an army of generational warriors into the battlefield.

Moreover, changes recently made by the Bureau of Labor Statistics in the way it calculates the consumer price index (CPI) will extend Social Security’s solvency further into the future. Some of these changes were recently incorporated into the trustees’ projections, which helped push the date of depletion of the trust fund two years further out, to 2034. There are other changes in the CPI that have been made over the last three years that have not been fully incorporated into the trustees’ projections. According to the Council of Economic Advisors, these changes would lower the measured rate of inflation by another 0.29 percentage points; the Congressional Budget Office has made similar estimates. If these changes were fully incorporated, the trust fund would remain solvent beyond 2043. (A lower inflation measurement boosts the trust fund because it means that both real wages—and thus the payroll taxes collected on them—and the real interest earned on the trust fund balance will be higher than expected.)
Social Security and Its Critics

There are other, nontechnical reasons to challenge the policies on which the trustees' projections are based. That is, their projections (aside from the preceding technical issues) may well be the best available forecast of the future economic conditions that will determine the revenue and payouts of the Social Security system, based on past and current trends, but the trends themselves may be challenged on political-economic grounds. For example, the trustees' intermediate projections assume an unemployment rate of 6 percent persisting throughout the period. Until four years ago, most economists considered the "non-accelerating-inflation rate of unemployment" (NAIRU), sometimes referred to as the natural rate of unemployment, to be 6 percent, meaning that, if unemployment were to drop below 6 percent, inflation would accelerate. The Federal Reserve Board was guided by this view in conducting monetary policy. But unemployment has been below 6 percent for several years in the late 1990s—often below 5 percent—while at the same time inflation has actually fallen.

There is now a strong case for abandoning the concept of NAIRU altogether, and indeed if we look at it historically, economists' definition of the natural rate of unemployment has tended to follow the actual rate. In any case, it is clear that a considerably lower rate of unemployment than previously thought possible without accelerating inflation is indeed feasible, and it is within the power of the Federal Reserve Board to make it a reality.

Similarly, we might question whether the 1.3 percent productivity growth projected by the trustees is unalterable. Again, the problem is not in the trustees' projections but in the notion that the underlying trend should be accepted. From 1948 to 1973, productivity grew at an annual rate of 2.5 percent. The sharp drop since then (to 1.2 percent) has drastically narrowed the economic possibilities for all affected generations. After all, it is rising productivity—output per unit of labor—that is the source of rising living standards. Economists do not agree on an explanation for the slowdown, but clearly there are policy changes that might affect the rate of productivity growth. One is the rate of growth of wages. Although rising productivity is a source of wage increases, the causality also runs in the opposite direction. Throughout much of its economic history, the United States had higher wages than Europe, and this gave employers an incentive to substitute capital for labor, which increases the productivity of labor. This increasing substitution of capital for labor is associated with more rapid technological change generally, since the new machinery almost always embodies more advanced technology than the old.
Chapter One

One problem we have in the present period is that the availability of labor at low and stagnating wages discourages this productivity-enhancing investment. It allows employers to create new jobs that have low levels of productivity, because they can pay low wages. The creation of these low-productivity, low-wage jobs slows the overall rate of growth of productivity in the economy.

It is commonly believed, especially in the popular literature, that rapid technological change leads to higher unemployment. But this is not true, either logically or historically. So long as macroeconomic policy is oriented toward full employment, technological change and its accompanying increases in productivity need not increase unemployment at the level of the whole economy. During the late 1960s, for example, when productivity was growing more than twice as fast as it is today, unemployment dropped to 3.5–3.8 percent (ERP 1998, table B-42). And the whole Bretton Woods era (1946–73) had considerably lower unemployment than the years since (4.7 percent vs. 6.8 percent), with vastly higher productivity growth (Mishel, Bernstein, and Schmitt 1999, 221).

It is therefore possible to have higher wage growth, faster productivity growth, and lower unemployment than we enjoy currently or assume in our economic projections. Such changes could not only balance Social Security’s finances but also allow us to address some of the nation’s more real economic problems. Moreover, all this is aside from the more pressing issues of the increase in wage inequality and the shift in income distribution from wages to profits, which are at least as vital to the debate.

It is a sad testimony to the intellectual emptiness of contemporary debates over economic issues that policies that have stunted our growth and continue to limit our possibilities for the future are taken—mostly unconsciously—as fixed. The source of our economic problems is then located in unalterable exogenous factors like demography or factors that are probably better understood as “dependent variables,” such as the savings behavior of individuals. It would seem to make more sense to push for policies that would result in higher wage and productivity growth and lower unemployment than to take the performance of the last two decades as our inevitable fate for the first three-quarters of the twenty-first century—and then obsess about the small possible gap in Social Security financing that might result. But myths can have a power that is greater than reality, and the myth of demography as destiny, in conjunction with others, has put the entitlement cutters in the driver’s seat.
Social Security and Its Critics

It must be emphasized that, however sensible and beneficial it would be to change the underlying growth trends in productivity, employment, and wages, the soundness of Social Security's financing does not depend on any such improvements in the overall economy. Throughout this book we accept, for the sake of argument, the trustees' intermediate cost projections and their underlying (rather pessimistic) assumptions. Should the predicted financing gap actually materialize, it would not necessarily have to be closed by a flat payroll tax increase. But in any case it is nothing to worry about. To understand the current debate it is necessary to examine, in some detail, the devices by which this potential molehill up the road has been transformed into a mountain in the middle of our backyard—indeed, if one is to believe the critics, a volcano that is about to erupt and bury our children and grandchildren under a suffocating burden of intergenerational income transfers.

The Disappearing Trust Fund

One of the most important efforts of Social Security's critics has been to undermine public confidence in the program's solvency. This brings them halfway to their goal, since people are less likely to defend the program from privatization or other changes if they don't think they have much of a stake in it. The critics' success can be measured by the number of times the words "looming insolvency" are used to describe the system's finances (see, e.g., Stevenson 1998b). "Looming" is a strong adjective to use for an event that won't occur until 2014, when benefits paid out are projected to exceed taxes received, but 2014 is a lot closer than 2034, which is how long it takes for the trustees' projections to show a shortfall. These guideposts have contributed to the widespread belief that the Social Security system will go broke when the baby boomers begin to retire, and so a closer look at this problem is important, and will provide a convenient way to illustrate some of the basics of the system.

Social Security is a pay-as-you-go system in that money taken from people's paychecks, as well as employers' contributions, goes to pay current retirees. This arrangement causes no small amount of indigestion among the system's conservative opponents, who would prefer a "fully funded" system that, much like a pension plan, would rely on an established pool of funds invested in financial assets. Benefits to retirees would be paid out of the returns generated by the fund's assets.

Primarily to prepare for the retirement of the baby boom generation, the Social Security trust fund has been building up a surplus since 1984. It cur-
rently stands at more than $800 billion and is now growing by about $100 billion a year. In order to get a return on this money, the trustees buy U.S. government bonds earning about 6.4 percent a year. These are perhaps the safest investment available in the world today.

The first baby boomers will begin to retire about 2008. As can be seen in table 1-2, by 2014 the benefits paid by the system will be slightly greater than the money coming in from payroll taxes. The "reformers" argue on this basis that Social Security will be in trouble in 2014 (see, e.g., Urban Institute 1998, fig. 7). But this is like saying that Bill Gates would have trouble paying his mortgage if he left his job at Microsoft. At the end of 2014, the fund will have nearly $2.3 trillion in assets (in today's dollars), and it will be receiving $138 billion in interest payments on top of its income from payroll taxes. In fact, the combined interest income and payroll taxes ($723 billion) will exceed benefit payments by $130 billion. With this contribution from interest payments, the fund will be able to pay all benefits out of its income until 2022. From that point until 2034, it will be able to maintain full benefit payments by drawing on the principal in the trust fund.

The alarmists are not so easily turned back. "But," they object, "when the trust fund cashes in its bonds, the government will have to find money somewhere. So Social Security—or some other spending—will have to be cut." On this basis they dismiss the trust fund’s assets as "mere pieces of paper" or "the government owing money to itself." Dubbed merely an accounting fiction, the trust fund vanishes. And so does the distinction between Social Security payroll taxes and the rest of government revenue. It's all just one big pot of money coming in, and one pot of money pouring out.

While it is indeed true that the government will have to borrow from other sources as the Social Security surplus shrinks, its need to borrow has nothing to do with the solvency of the Social Security system. One way to see this is to imagine that the Social Security trust fund were invested in private stocks and bonds rather than government bonds. When the system's payouts begin to exceed its income, the fund would begin cashing in its portfolio, and the proceeds would be used to help pay benefits, right up to 2034. Since this money would come from the private sector, no one could claim that the federal budget was being strained by Social Security spending. It is difficult to

1. It is worth noting that the difference between the income of the trust fund and its obligations in 2022 amounts to 1.0 percent of gross domestic product (GDP), increasing to
Table 1-2. Estimated Operations of the Combined Old-Age and Survivors Insurance and Disability Insurance Trust Funds in Constant 1999 Dollars, 1999–2033 (in billions)

<table>
<thead>
<tr>
<th>Calendar year</th>
<th>Income excluding interest</th>
<th>Interest income</th>
<th>Total income</th>
<th>Outgo</th>
<th>Assets at end of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>464.3</td>
<td>54.1</td>
<td>518.3</td>
<td>394.0</td>
<td>886.8</td>
</tr>
<tr>
<td>2000</td>
<td>469.4</td>
<td>57.7</td>
<td>527.1</td>
<td>400.7</td>
<td>995.1</td>
</tr>
<tr>
<td>2001</td>
<td>477.7</td>
<td>62.0</td>
<td>539.7</td>
<td>408.3</td>
<td>1,102.5</td>
</tr>
<tr>
<td>2002</td>
<td>484.7</td>
<td>66.8</td>
<td>551.4</td>
<td>417.6</td>
<td>1,208.5</td>
</tr>
<tr>
<td>2003</td>
<td>492.0</td>
<td>71.8</td>
<td>563.8</td>
<td>426.9</td>
<td>1,313.1</td>
</tr>
<tr>
<td>2004</td>
<td>499.0</td>
<td>77.0</td>
<td>576.0</td>
<td>436.7</td>
<td>1,414.0</td>
</tr>
<tr>
<td>2005</td>
<td>507.8</td>
<td>82.7</td>
<td>590.5</td>
<td>447.4</td>
<td>1,514.0</td>
</tr>
<tr>
<td>2006</td>
<td>515.7</td>
<td>88.6</td>
<td>604.2</td>
<td>459.1</td>
<td>1,612.1</td>
</tr>
<tr>
<td>2007</td>
<td>525.0</td>
<td>94.7</td>
<td>619.7</td>
<td>471.4</td>
<td>1,709.7</td>
</tr>
<tr>
<td>2008</td>
<td>533.0</td>
<td>101.0</td>
<td>634.0</td>
<td>484.4</td>
<td>1,804.8</td>
</tr>
<tr>
<td>2009</td>
<td>542.1</td>
<td>107.9</td>
<td>649.9</td>
<td>499.8</td>
<td>1,897.3</td>
</tr>
<tr>
<td>2010</td>
<td>551.3</td>
<td>114.6</td>
<td>665.9</td>
<td>516.0</td>
<td>1,986.6</td>
</tr>
<tr>
<td>2011</td>
<td>560.0</td>
<td>121.3</td>
<td>681.3</td>
<td>533.0</td>
<td>2,071.3</td>
</tr>
<tr>
<td>2012</td>
<td>568.3</td>
<td>127.8</td>
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Source: Office of the Chief Actuary, Social Security Administration (April 9, 1999).
Note: Based on intermediate-cost assumptions of Social Security trustees (SSA 1999).

1.6 percent of GDP in 2027 (it is likely that revenues would be increased by then) and 1.9 percent in 2033. These would represent significant but not extremely high levels of borrowing; the federal budget deficit in 1983, for example, was 6.1 percent of GDP. But for those who consider this to be a serious problem, it is important to clarify that the source of the problem lies outside Social Security, and that the fact that the Social Security system has loaned its
see why the composition of the trust fund’s portfolio should make any difference. The alarmists would have us believe that the fund is not a separate entity, simply because its surplus is invested in U.S. government bonds. This assertion contradicts the entire history of the system, as well as the law itself. Since 1935, taxpayers have paid specially designated payroll taxes and received their benefits from these same funds.

What does it mean, then, to say that Social Security must be cut rather than that the government must meet its obligations to the trust fund? When the government bonds held by Bill Gates or Ross Perot or any other wealthy individual or pension fund mature, nobody proposes that the creditors should not be paid their principal. Yet the reformers insist that the 144 million Americans who loan money to the U.S. Treasury from the Social Security trust fund somehow do not have the same claim. One reason they are able to get away with this assertion is that the Treasury’s current borrowing from the trust fund is not counted as part of the federal unified budget deficit. Thus, the budget was considered in surplus in 1998 when government borrowing from other sources was reduced to less than zero, even though it was still borrowing $100 billion from Social Security. If not for this accounting convention, we would have had an approximately $31 billion budget deficit.

In 1999 the annual surplus, excluding interest, of the Social Security trust fund was projected to reach its peak. From that point, the annual amount that the Treasury can borrow from the trust fund falls, and it is at this point that Social Security begins to “add to” the federal budget deficit. But this is merely an accounting convention: in reality, the federal government will simply begin to replace some of the money that it had previously borrowed from the trust fund with money borrowed from other sources. Since the borrowing from Social Security was not counted as part of the budget deficit, but the borrowing that replaces it is counted, the budget deficit grows.

Demography as Destiny

In an era in which each passing month sees another social problem or phenomenon—beauty, crime, mental illness, obesity, adultery, divorce—proclaimed to be a product of biological evolution, economics has been relatively surplus to the federal government rather than having invested it in private stocks or bonds should not be used to make Social Security beneficiaries pay, in the form of reduced benefits, for any fiscal tightening that may be applied to the rest of the budget.
Social Security and Its Critics

lucky to preserve its character as a social, rather than a natural, science, in spite of the self-imposed irrelevance or antisocial biases of its high theory. However fantastic the assumptions of its microfoundations, or truncated its conception of society as a collection of individual specimens of Homo economicus interacting through market transactions, economics has at least continued to seek social, and not biological, explanations for the phenomena under its purview. That being the case in the realm of theory, the policy arena is easily diverted by intellectual fads. So we should not be surprised at the receptive audience, inundated as it is with late-twentieth-century biodeter-minism, that can be found for an argument that derives a large part of our macroeconomic future from demographic trends. Everyone knows that there was a big spike in the birthrate beginning about 50 years ago that created what is called the baby boom generation. Countless feature stories in the popular media have tracked how the aging of the baby boomers has influenced everything from congressional elections to classic-rock radio stations around the country. If one generation is large enough to exert such a profound influence over our politics and culture, it is only natural to believe, especially if the story is repeated enough, that this cohort’s retirement will hit the economy like an asteroid crashing into Earth.

One’s suspicions might be aroused by the fact that we fed, clothed, housed, and educated all these people when they were dependents and still managed to invest enough to create the most rapid period of growth in American economic history. If we could take care of these people when they were young, why should it place an intolerable strain on our economy to provide for their retirement—especially when that economy is going to be three to four times the size of the one that sustained the baby boomers until they were ready to enter the labor force?

The doomsayers have selectively used a raft of statistics to buttress their case. For example, we are often told that the population of senior citizens (over 65) is expected to double by 2030, from 35.2 million today to 68.4 million. However, the rate of increase over the last 33 years was not that different: we went from 18.5 million senior citizens in 1965 to 35.2 million in 1999. These numbers by themselves do not mean very much. For example, if the

2. Richard Leone 1997 has emphasized this point.
3. For an example of this selective presentation, as well as the use of other devices discussed in this chapter, see Urban Institute 1998.
elderly were 1 percent of the population, then even if they doubled in percentage terms to 2 percent, no one would be worried. In fact, the proportion of people over 65 is 12.7 percent today and will grow to 20 percent by 2030. At the same time, the economy is projected to grow by 59 percent. Can an economy that is 59 percent bigger support an increase of this size in its retired population? There is little reason to doubt that it can, and, as we will see, with little adverse impact on the rising living standards of the rest of the nation.

Another statistic played up by the reformers is the ratio of workers to retirees. It is often noted, for example, that the number of workers paying Social Security taxes for every retiree drawing benefits will fall from 3.3 today to 2.1 by the year 2030 (SSA 1999, table II.F19). It is thus argued that the system will become unsustainable without serious benefit cuts. But the decline in this ratio has actually been considerably steeper in the past. In 1955 there were 8.6 workers per retiree, and the decline from 8.6 to 3.3 did not precipitate any economic disaster.

These figures also neglect to take into account the reduced costs faced by the working population from having a smaller proportion of children to support. A more accurate measure of the actual burden faced by the employed labor force would be the total dependency ratio, which includes both retirees and children relative to the number of workers. This ratio is projected to increase from 0.708 today to 0.796 in 2035 (SSA 1999, table II.H1). This is not a huge increase, and the latter figure is considerably below the ratio for the year 1965, which was 0.947. Thus, it seems that, in comparison to the past, the increase in the future burden of caring for a larger elderly population will be offset to a large extent by the reduced costs of education, child care, and other expenses of caring for dependent children (SSA 1999, table II.H1).

But even without taking into account the reduction in costs associated with the smaller number of children in the future, the figures on the number of elderly and the ratio of workers to retirees are misleading because they are taken so drastically out of context. To say that Social Security will go broke because of the declining number of workers per retiree is like saying that we should be very hungry right now because the percentage of the workforce in agriculture has declined from 5.1 to 1.1 over the last 40 years. The problem is that simple dependency ratios do not take into account productivity increases. Just as we can now feed the nation and in fact export a large agricultural surplus with vastly fewer people employed in agriculture, it is also true that fewer workers can support a larger number of retirees as the productivity of
the entire economy grows.

This example illustrates how meaningless it is to cite scary-looking demographic or labor force statistics in isolation. In order to project the state of Social Security's financing in the future, it is necessary to take into account all of the variables that affect both revenue and payouts, including the aging of the population, the rate of growth of the labor force and wages (the latter are related to productivity growth), projected rates of unemployment, and interest rates. The Social Security actuaries have incorporated these trends, and the results are, as noted above, quite reassuring. Since the reformers are not willing (or able) to make the case that the trustees' intermediate assumptions are overly optimistic, they cannot challenge the results—and they do not. But that does not prevent a lot of people who, for various reasons, would like to create the impression that Social Security faces serious problems from focusing on whatever portions of the overall picture will make their case appear plausible.

Unfunded Liabilities, Ponzi Schemes, and Other Rhetorical Devices

Social Security's detractors have a few other tricks they like to throw into the mix in order to create the impression that the whole system is some kind of a scam. One of these is the concept of "unfunded liabilities." The argument is based on a view of Social Security that likens it to a private pension system. With this model in hand, Peter Peterson warns us that "the federal government has already promised to today's adults $8 trillion in future Social Security benefits beyond the value of the taxes they have paid to date." On this basis he concludes that the system has $8 trillion in "unfunded liabilities" (Peterson 1996, 44). This is a big number, and it is quite meaningless. Social Security is not a private pension system. Private pension systems do not have the power to collect a payroll tax from 144 million employees and their employers. As noted above, retirees who are receiving Social Security benefits this year are paid from the contributions of workers who are currently employed (and their employers); for the next 30 years, these payroll taxes will amount to an average of more than $550 billion per year. The fact that the system is currently taking in more than it pays out, and is accumulating a surplus in anticipation of the increase in payouts as the baby boomers retire, does not alter the system's basic "pay-as-you-go" financing. In such a system, it makes no sense to compare the program's committed payouts to money already collected in the past. All that matters is the balance between
future revenues (including the accumulated assets of the trust fund and its returns) and future payouts. And on that score, the program is secure for the foreseeable future.

As will be explained in chapter 7, there is little economic reason to favor a fully funded system over a pay-as-you-go setup, since there is no reason to believe that national savings would be any higher under a fully funded system. Part of the hostility toward a pay-as-you-go system results from the fact that this is one of the few ways that income can be redistributed from the current generation of workers to their elders. The Social Security system was designed to do just that, on the idea that each generation has a higher standard of living, on average, than its predecessor. And that higher standard of living is based on the sacrifices of previous generations, which helped to build the capital stock and infrastructure that enable current generations to enjoy the benefits of the resulting gains in productivity. For those who are against the redistribution of income as a matter of principle, pay-as-you-go is difficult to swallow.

Some of the program’s most vocal critics have therefore attacked Social Security as a “Ponzi scheme,” that is, a pyramid scheme in which the first participants benefit at the expense of those who join in after them, with the whole structure collapsing underneath the hapless Generation X or perhaps their progeny. Exhibit A in this argument is the declining rate of return on Social Security contributions. For example, an average-income, single, male employee born in 1920 would have received an expected real return of 2.73 percent on his contributions, as opposed to 1.37 percent for someone born in 1943.

It is indeed true that in a pay-as-you-go system the rate of return will decline from the time the system is initiated until it reaches maturity. The program was signed into law in August 1935, and the first beneficiaries, who began to receive benefits in 1945, had paid into the system for only a short time. It was not until the late 1970s that the first cohorts of workers who had paid into the system for their whole working lives began to retire; in the meantime, the total number of retirement beneficiaries drawing benefits has grown from 1.3 million in 1945 to 37.9 million in 1998 (SSA 1999, table II.H2). As a result of these dynamics, the payroll tax has been steadily increased: from 1.0 percent in 1936 to 6.2 percent on both the employee and the employer today. In 1983 benefits were also cut significantly by raising the retirement age to 67 (phased in for retirees beginning in the year 2000).

There is nothing particularly sinister about the declining rate of return
generated by the arithmetic of a pay-as-you-go system. The alternative in 1935 would have been to postpone the initiation of Social Security for a few generations until a collective pension fund could have been built up, with payments based on the returns generated from these assets. This was not an attractive option in the middle of the Great Depression, when so many senior citizens, as well as their families, were impoverished. The nation opted instead for a pact between generations, and this accord has been maintained. Is it unfair that earlier recipients received a higher return for their contributions? Perhaps some will see it that way, but how many Generation X-ers would trade their grandparents’ return on Social Security taxes and also their lifetime income for their own? This is what really matters: not that the rate of return on each individual’s payroll taxes is equal across all generations, but that no particular cohort has to make inordinate sacrifices with regard to their standard of living. There is no plausible scenario under which the obligations of the Social Security system could cause this to happen to future generations. (This argument is explained more thoroughly in chapter 2.)

Advocates of privatization have recently crafted appeals based on the idea that various demographic groups could earn a better return from a privatized account. Their arguments are based on a number of flawed assumptions, such as exaggerated estimates of the rate of return that people could earn in the stock market (see chapter 5). However, there is one particular appeal that has entered the discussion only recently: the argument that African Americans get a much lower return than whites from Social Security and would therefore be better off with a privatized alternative. The Heritage Foundation, in a report that received a fair amount of attention in the press (Stevenson 1998d), has made this claim (Beach and Davis 1998).

Because of the large difference in life expectancy between African American and white men, African American men get a much lower return than their white counterparts in terms of retirement benefits. In fact, there are similar differences in life expectancy by income and occupation irrespective of race (Rogot, Sorlie, and Johnson 1992). But the Social Security system also provides benefits to survivors of deceased workers and to disabled workers, and about 25 percent of the children who receive survivor benefits and about 18 percent of the recipients of disability awards are black. Since African Ameri-

4. Past and projected life expectancies are from the National Center for Health Statistics and the Office of the Actuary, Social Security Administration.
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cans compose about 12 percent of the population, their claim on survivor and disability benefits compensates for at least part, if not all, of the reduced retirement benefits they get from Social Security.

The calculation that African Americans would get a higher return from privatized accounts not only excludes the survivor and disability portions of the system, but also the transition costs that would be necessary in any switch to a privatized system. Today’s Social Security beneficiaries are paid from current payroll taxes. Diverting these payroll taxes into private accounts would require a wait of 40 years before a retiree could draw benefits from the principal. In the meantime, retired workers would still have to be paid. Thus, for several decades employees would have to pay two sets of taxes: their mandatory contributions to private retirement accounts, plus the taxes necessary to support all those who are already drawing benefits. These transition taxes are significant: under the main partial privatization plan advanced by a faction of the 1997 Advisory Council on Social Security, transition costs were estimated at 1.52 percent of payroll, spread out over the next 72 years. And that plan proposed to divert only about half of Social Security payroll taxes into “personal security accounts” (PSAs). If we add the transition taxes into the calculation, it can no longer be asserted that African American men, or any other demographic group, would fare better under a privatized system—in fact, their returns would be negative for the next few generations.

Although privatization would only worsen the situation, the enormous disparity in retirement years across racial and class lines raises profound issues of public health in the United States. Social Security alone cannot resolve these problems; they will have to be addressed through other policies such as national health insurance, occupational health measures, and, perhaps most important, efforts to reduce poverty and income inequality. To the extent that the Social Security system can be made more progressive in its tax and benefit structure, it could in the meantime provide some counterbalance to these disparities in years of retirement. Ironically, almost all advocates of Social Security reform—including those who favor privatization—want to raise the retirement age, a step that would greatly aggravate racial disparities in the system based on life expectancy (see chapter 6).

In sum, there is no “demographic tidal wave” that will drown Social Security’s finances in the ensuing decades. The baby boomers’ retirement has already been taken into account, and there is no need for further benefit
cuts. And there is no pyramid scheme or diversion of Social Security’s revenues to other purposes. Any shortfall that might occur 30 or 40 years down the road will be easily handled by a population that has much greater income than we have today. Any assertion to the contrary is false and misleading and can be supported only by taking selected demographic and economic projections out of context, or through other sleights of hand.