Waiting to address a shortfall could worsen problems, analysts warn

By Jay Fitzgerald
Globe Correspondent / June 12, 2011

Social Security, the federal government's old age pension system, is under increasing pressure as baby boomers begin to retire in vast numbers, draining the system's trust fund and adding to concerns about the nation's long-term debt.

Specialists agree Social Security's financial woes aren't nearly as complex or immediate as those facing Medicare, the health insurance program for the elderly that must contend with rising medical costs as well as increasing enrollment.

But with Social Security projected to exhaust its main trust fund by 2036, economists believe Washington has to act soon to show nervous financial markets that it's addressing the nation's burgeoning debt, starting with the federal government's largest program — Social Security.

"The sooner we act on it, the better,'' said Andrew G. Biggs , a resident scholar specializing in public pension systems at the American Enterprise Institute, a Washington think tank. "Social Security is probably the one program you can compromise on in Washington. You could theoretically split the difference, through a combination of tax hikes and benefit cuts.''

History: Created in 1935 during the Depression, Social Security was designed to provide a minimum safety net for the elderly, many of whom lived in bitter poverty in an era when few had pensions. Over the course of its 76 years, Social Security became the "third rail'' of American politics, zapping politicians who dared push too hard for changes to the popular program.

President George W. Bush learned that when his proposal to partially privatize Social Security fell flat with lawmakers, who had no desire to overhaul the program.

Though nervous about touching the system, Congress has periodically intervened to keep it solvent. In the 1980s, a presidential commission led by Alan Greenspan, later the Federal Reserve chairman, recommended adjustments that many believed put Social Security on solid footing for decades.

The problem: Social Security's problem is relatively straightforward: Too many people will retire in coming years, and revenues from the system's payroll taxes won't keep up with benefit payouts.

The number of Social Security recipients is expected to explode to about 72 million people by 2021, up from today's 55 million, while the annual cost of the program will leap to $1.27 trillion from $733 billion, according to the Congressional Budget Office.

Already, the annual cost of Social Security benefits is outstripping revenues from payroll taxes, requiring the system tap its reserve fund, said Henry J. Aaron, an economist and senior fellow at the Brookings Institution, a Washington think tank. Eventually, the $2.6 trillion fund, composed mostly of Treasury bill holdings, will be depleted — by 2036, according to projections.

After the fund is emptied, Congress — and the nation — would face simple and stark choices to meet obligations to the elderly: slashing benefits, raising payroll taxes, or both.

Economists say Social Security's financial problems are big, but not complex. Since there are no hospitals, doctors, and other providers to negotiate prices with each year, Social Security doesn't need the type of radical overhaul that many believe Medicare needs.

"Relatively small adjustments [to rules and taxes] would fix it,'' said Aaron.

Potential solutions: Biggs said an immediate 2.2 percentage point increase in the Social Security payroll tax, to 14.6 percent from the current 12.4 percent, would keep the system solvent for more than 75 years, well into the second half of this century. Such an increase would cost a worker making $50,000 a year about $1,100 annually.

But raising taxes during this economically fragile time could hamper business and consumer spending, said Biggs. And while congressional Democrats may support a tax increase solution for Social Security, Republicans controlling the House of Representatives generally oppose higher taxes.

As a result, any compromise would likely contain a mix of tax increases and benefit reductions. For example, the earliest age to qualify for Social Security benefits, now 62, could be raised, in part to reflect longer life expectancies.

Lawmakers could also explore "means testing,'' in which wealthier recipients receive lower benefits or pay more into the system, or both, economists said.

Whatever solutions lawmakers choose, it's better they act soon, economists said. Each delay compounds the program's financial problems, which in turn would require more drastic tax increases, benefit cuts, or both.

"If we wait too long,'' said Biggs, "we're only going to be in rougher shape down the road.''■

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Day of reckoning

While Washington debates how to fix America’s safety net, the real-world stakes are getting higher

By Jay Fitzgerald
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For the better part of 20 years, lawmakers and policy makers have talked about the oncoming wave of aging baby boomers and exploding costs of Social Security and Medicare, warning that the nation faced a day of financial reckoning unless it brought spending on these popular entitlements under control.

That day, if not quite here, is fast approaching — within months, or even weeks, according to one prominent economist — and political leaders in Washington are still talking. As the first of nearly 80 million baby boomers turn 65 this year, when and how Washington addresses rapidly rising entitlement costs and, consequently, the burgeoning national debt, will have vast implications for business and the economy.

If something isn’t done relatively soon, economists say, higher interest rates, a weaker dollar, increased payroll taxes, and deep cuts to other federal programs are among potentially dire consequences that could mean slower growth, higher unemployment, and lower standards of living.

The stakes for Massachusetts are particularly high since many of its key industries, including technology, biotechnology, and hospitals, depend heavily on federal spending for defense, scientific research, and health care.

“Business executives should be very concerned,’’ said Jonathan Gruber, an economics professor at the Massachusetts Institute of Technology. “The business community has a huge stake in keeping the federal government solvent.’’

Among the potential consequences:

Higher borrowing costs. As the government floods financial markets with debt to meet entitlement obligations, it would likely have to offer higher interest rates to attract buyers of its bonds. Those higher rates would trickle through the economy, affecting everything from auto loans to corporate bonds.

A further weakening of the dollar. As currency investors lose faith in the government’s financial state, the relative value of the dollar would fall, reducing Americans’ purchasing power. US products would become less expensive to foreign customers, increasing exports, but imported goods, from electronics to cars, would become more expensive here.

Increases in payroll taxes to support Medicare and Social Security. Businesses currently chip in half of the 2.9 percent Medicare tax and half of the 12.4 percent for Social Security taxes. Employees pay the rest. Any grand compromise on Medicare and Social Security would probably increase taxes.

Cuts in other federal programs. If more taxpayer money is funneled to Medicare and Social Security, there would be less money for defense, research, education, and other federal programs important to the Massachusetts economy.

Disruptions to the health care and biopharmaceutical industries. Medical cost saving initiatives, especially changes to the Medicare payment system for health services and drugs, could shake up these key Massachusetts industries.

As difficult as the issues appear, economists across the political spectrum said Washington can't wait much longer to begin addressing entitlements, viewed as main drivers of the long-term national debt.

Combined Social Security and Medicare spending is projected to nearly double over the next 10 years to $2.2 trillion, from $1.3 trillion, and accelerate as more baby boomers flood the systems. Baby boomer retirements are expected to peak early next decade.

The problem comes if financial markets lose confidence in the nation's ability to manage these costs and pay its debt; witness the global financial turmoil and drag on economic growth from the debt problems of Greece, which has an economy just a fraction of the size of the US economy.

When such a crisis might happen here is anyone's guess, but the risks increase the longer it takes US leaders to agree on a plan, economists said. Laurence Kotlikoff, a professor of economics at Boston University and an expert on entitlements, said it could happen sooner than anyone expects.

"I think we can see a meltdown within the bond markets within five weeks if we don't do anything,'' he said. "I could be wrong. But too many people are nervous these days. Markets can move very quickly. We're playing with fire.''

Most other economists say the nation has about five years to start making a serious dent in projected Medicare and Social Security deficits.

But they are also not discounting the possibility of a rapid deterioration of markets if Washington doesn't send a signal that it's addressing long-term budget woes.

Currently, political leaders appear at a standoff. The Republican-controlled House recently passed a plan to overhaul Medicare by providing government vouchers to help seniors buy private health insurance. The Democratic-controlled Senate rejected that plan.

Meanwhile, there has been little discussion of possible compromises to address Social Security's problems. Republicans and Democrats can't even agree on whether to raise the nation's debt ceiling to pay for today's programs.

Economists say lawmakers can't waste much more time.

"Markets are forward looking,'' said William Cheney, chief economist at Boston's John Hancock Financial Group. "If the markets see that nothing is getting done, then the markets can quickly lose their tone and confidence.''

Cheney doesn't see an immediate crisis as severe as those in Greece, Spain, and other European countries struggling with long-term debt.

"But my big fear,'' he added, "is that we'll get hit suddenly and fast by markets, causing turmoil and making it more difficult to react. It could happen at any time.''■

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