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THE SOCIAL SECURITY DEBATE IN THE UNITED STATES

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THE SOCIAL SECURITY DEBATE IN THE UNITED STATES

INTRODUCTION

Social Security in the United States is a mandatory, contributory social insurance program that provides wage earners with a basic level of income during retirement. It collectively spreads the risk of diminished income due to retirement, disability or death. It protects retirees from the risks of inflation, financial market fluctuations, and outliving one's retirement assets.[1]

Social Security was designed as a pay-as-you-go program whereby the contributions of today's workers pay for the benefits of today's retirees. It was introduced in 1935 to mitigate the effects of poverty facing the elderly during the Great Depression. It has since grown to provide over $518 billion in benefits to roughly 48 million Americans in 2005. However, actuarial forecasts predict that program benefits will outstrip contributions by 2017 due to the large number of baby boomers who are soon expected to retire.

Social Security reform in the United States has become one of President George W. Bush's chief domestic issues. While many oppose the use of the term "crisis" to frame the debate over Social Security, it is generally agreed that something must be done to improve the actuarial balance of the program. Various reform options are available, such as an increase in payroll taxes (or other taxes), reductions in program benefits, an increase in government debt, reductions in spending on other government programs, and an increase in the investment return provided by the two Social Security trust funds.

Much of the debate, however, centres on the Bush administration's proposal to replace part of the existing pay-as-you-go feature of the program with personal savings accounts. These accounts would not reduce the actuarial imbalance by themselves, but they mark an ideological shift in the design of the program.[2]

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(1) Peter A. Diamond and Peter R. Orszag, "Saving Social Security," *Journal of Economic Perspectives*, Vol. 19, No. 2, Spring 2005.

(2) *Ibid.*

This paper will first briefly explore the origins and development of Social Security in the United States. It will then look at the issues related to the current Social Security debate and review the options for reform, including the proposal to introduce personal savings accounts. Finally, it will contrast the current debate in the United States with the Canada Pension Plan reforms to which the federal and provincial governments agreed in 1997.

ORIGINS AND DEVELOPMENT OF SOCIAL SECURITY IN THE UNITED STATES

A. Origins

The U.S. Social Security program received its legislative birth when the *Social Security Act*(3) was enacted on 14 August 1935. The Act was initiated by President Franklin D. Roosevelt during a prolonged period of economic upheaval. It was seen as a popular outcome and a cornerstone of the President's New Deal, an initiative associated with a series of government programs to respond to the hardship and lack of market confidence that grew out of the Great Depression.(4) Social Security was introduced during a time when many believed that a quick economic recovery was improbable, but it also grew out of a period of social change.(5)

The original Act provided only retirement benefits, and only to retired workers aged 65 or older. The program was set up on a pay-as-you-go basis whereby current workers and employers paid the current benefits of retired workers. Contributions were calculated based on a 1% tax paid by each of the employer and the employee on the first $3,000 of earned income. The amount of contribution that exceeded payouts was accounted in a trust fund.

Critics of the new Social Security program argued that charity or welfare programs were better means to assist the elderly, that the tax burden would be onerous on businesses, and that the program would eliminate private old-age insurance options. The *Social*

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(3) In addition to a national contributory social insurance program for retired workers, the Act included unemployment insurance, grants to states for old age assistance, aid to dependent children and grants to states for medical care. Initially, the Act did not include disability coverage and medical benefits; these were introduced later.

(4) See U.S. Social Security Administration, *Social Security: A Brief History*, August 2005, http://www.ssa.gov/history/. It should be noted that social insurance programs were not a new concept; they had already been introduced in many European countries.

(5) The United States experienced substantial increases in productivity and the standard of living between 1890 and 1930. Many people were leaving rural communities to find work in cities and there was considerable improvement in average life expectancy for both men and women.

Security Act was subject to constitutional court challenges that questioned whether the federal government had authority to implement such a program. The Act was successfully defended based on broad federal powers granted under the Constitution to levy taxes and expend funds.(6)

B. Key Developments

Social Security has undergone several expansions since its origins in 1935. The first expansion was the inclusion in 1939 of two new categories of benefits: payments to dependants and survivors (wives/widows, young children and elderly parents) of workers covered under the program. In 1950, the program broadened its coverage again to include employed farm and domestic workers, self-employed workers and certain federal employees. Notably, dependent husbands and children of insured women workers became eligible for benefits. Cost of Living Allowances (COLA) were first introduced during the 1950 amendments in recognition of the erosion of benefits due to inflation.

In 1956, disability benefits for workers and their dependants were introduced, funded by a new payroll tax. A disability trust fund was also established. In 1961, the age of pension eligibility was lowered to 62 years with corresponding actuarially reduced benefits.

Benefit reductions and increases in payroll taxes were introduced in 1977 to avert a shortfall in the fund, predicted by 1979 as a result of rapid inflation and an economic recession. Reforms in 1983 raised payroll taxes beyond the amount required for pay-as-you-go coverage; they also included partial income taxation of benefits and a scheduled increase in the eligible age of full retirement from 65 to 67 by the year 2027. The goal was to reduce costs and accelerate payments into the Social Security trust fund to accommodate future financial pressures caused by retiring baby-boomers. In 2000, the means test for recipients who have attained full retirement age was eliminated.(7)

CURRENT SYSTEM

Participation in Social Security is widespread, with more than nine out of ten seniors receiving some form of Social Security payment. These payments make up the majority of income for more than two-thirds of elderly people in the United States. They are virtually the

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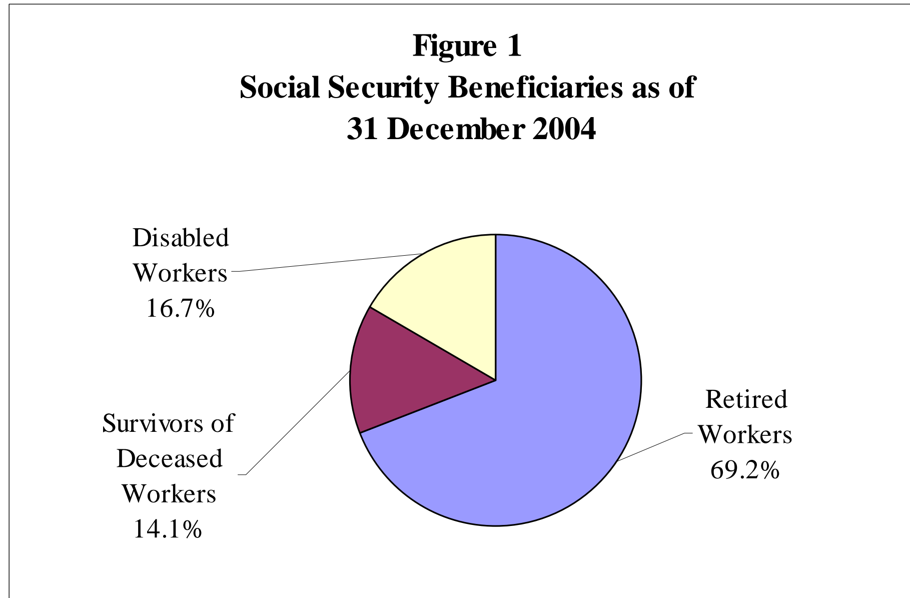
(6) Geoffrey Kollmann and Carmen Solomon-Fears, "Major Decisions in the House and Senate on Social Security: 1935-2000," *Social Security Online*, 26 March 2001, http://www.ssa.gov/history/repstud.html.

(7) *Ibid.*

only source of income for more than one-third of elderly U.S. residents. There are currently 47.7 million beneficiaries of Social Security. Not all of them are retirees and their families; nearly one-third of beneficiaries are disabled workers and their families, and survivors of deceased workers (see Figure 1).[8] The average monthly benefit is roughly $955 per retired worker and $1,574 per retired worker and elderly spouse.



Source: U.S. Social Security Administration.

Currently, the Social Security payroll tax is 6.2% of earnings applied to a maximum annual amount of $90,000. That maximum is automatically indexed based on the annual increase in consumer prices. The tax rate is matched by employers, forming a combined rate of 12.4% of earnings; this is the rate imposed on the self-employed.

Nearly every worker is required to contribute to the program. State and local government employees are the only large group that is excluded from the system; they have their own similar retirement pension schemes.

Benefits are calculated using the best 35 years of average annual earnings indexed to the growth in wages. The benefits formula is progressive[9] and overall it is designed to

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(8) Social Security Online, *Social Security Legislation and Congressional Affairs*, Internet site, http://www.ssa.gov/legislation/.

(9) Benefits (or primary insurance amounts) are calculated by adding: 90% of the first $627 per month of average indexed monthly earnings (AIME), plus 32% of AIME over $627 to $3,779, plus 15% of AIME over $3,779.

replace roughly 40% of earnings for retirement, although the replacement rate varies depending on the level of earnings.[10] To be eligible for retirement benefits, the recipient must earn a certain minimum amount of income and must have worked for at least 10 years.[11] For disability benefits, the eligibility criteria are less stringent depending on the age of the recipient. Eligible recipients receive a minimum pension benefit that varies with the number of years of coverage.

A recipient may collect retirement benefits at a reduced rate starting at 62 years of age. In 2005, a recipient is eligible for full retirement benefits at age 65 and 6 months. As a result of reforms adopted in 1983, the age threshold for full retirement benefits will increase by two months every year until age 67, which will be reached by the year 2027. A portion of benefits is subject to income taxes; this amount varies depending on the level of income and individual or joint filing status.

The Social Security payroll tax pays the current benefits of today's Social Security recipients. The amount that is left over is deposited into trust funds, which are held as special Treasury Bills. There are two Social Security trust funds: Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI). These funds can be used only to finance Social Security's administrative costs and benefits. Under the *Social Security Act*, a Board of Trustees[12] is charged with overseeing the financial operation of the OASI and DI trust funds, and reports annually to Congress on the financial and actuarial state of the funds.

In its 2005 annual report,[13] the Board of Trustees forecast that Social Security payroll taxes will be able to cover the full amount of Social Security benefits until 2017, at which time the assets (i.e., special Treasury Bills) in these trust funds would have to be used to help pay benefits (see Figure 2). The Board expects that the accumulated assets in the funds will provide full benefits to recipients until 2040, after which the funds will provide only partial benefits (e.g., 74% of scheduled benefits as of 2041 and 68% of scheduled benefits as of 2079).

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(10) The long-range constant replacement rate for a low earner is 55%; for a medium earner it is 41% and for a maximum earner it is 27%.

(11) Eligibility is based on a system of credits; the eligible recipient must earn 40 credits to qualify for benefits. In 2005, a worker would have to earn $920 to receive one credit; the maximum number of credits per year is four.

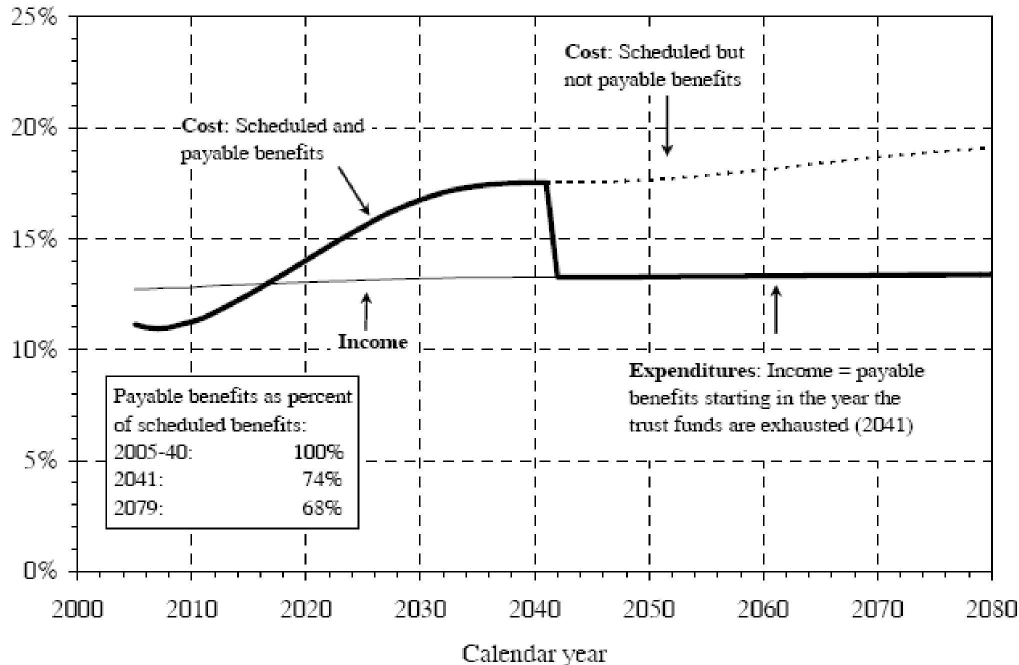
(12) There are six trustees: three federal cabinet members, the Commissioner of Social Security and two members appointed by the President and confirmed by the Senate.

(13) *The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Funds*, Washington, 5 April 2005, http://www.ssa.gov/OACT/TR/.

Figure 2

Old Age Security and Disability Insurance
Income and Cost Rates Under Intermediate Assumptions

(expressed as a percentage of taxable payroll)



Source: Board of Trustees (2005), p. 8.

The baby boomers – people born between 1946 and 1964 – will sharply increase the cost of the program when they retire. In 1950, the worker-to-beneficiary ratio was 16:1. In 2004, the ratio was 3.3:1; and by 2030, when the baby boomers have all retired, the ratio is expected to be 2.2:1. This ratio is forecast to decline still further after 2030. Also, the increase in life expectancy is contributing to the shortfall in future funding of Social Security. These anticipated cost pressures have sparked warnings of a financial crisis within the Social Security system.

PROPOSED REFORMS

Social Security reform has become a key domestic issue for President George W. Bush. In 2001, President Bush appointed the Commission to Strengthen Social Security to address the problem. The President imposed certain restrictions on the scope of the Commission's proposals, most notably that Social Security payroll taxes must not increase and

that any proposal must include individually controlled voluntary personal retirement accounts, which are essentially designed to set aside part of the Social Security payroll tax in individual accounts for contributors.

The Commission tabled its report[14] in December 2001; but the events of 11 September 2001 shelved the debate until 2004. The Commission strongly endorsed personal retirement accounts and saw this option as an inevitable evolution of Social Security: "[r]egardless of how policymakers come to terms with the underlying sustainability issues, however, one thing is clear to us: the time to include personal accounts in such action has, indeed, arrived."[15]

Consistent with the mandate given to the Commission, key elements of Social Security reform proposed by the Bush administration[16] are: no payroll tax increases;[17] no changes in the program for citizens born before 1950; and the introduction of personal retirement accounts. The introduction of personal retirement accounts would not, in itself, resolve the actuarial deficit of the program; therefore, benefit reduction options are being considered, such as indexing benefits to prices rather than wages, or changing the way in which benefits are calculated.

THE SOCIAL SECURITY DEBATE

A. Is Social Security in Crisis?

The issue of a financial shortfall in Social Security is not a new one, although it has been framed lately as a crisis. President Bush has stated that the system, "on its current path, is headed toward bankruptcy."[18] The 2001 Commission appointed to look at the program declared it to be broken. Others refute these views as an "attempt to frighten the American public" or as "sheer, mean-spirited nonsense."[19]

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(14) Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for all Americans*, 21 December 2001, http://www.csss.gov/reports/Final_report.pdf.

(15) *Ibid.*, p. 9.

(16) The White House, *Strengthening Social Security for the 21st Century*, February 2005, http://www.whitehouse.gov/infocus/social-security/200501/strengthening-socialsecurity.html.

(17) There may, however, be some flexibility to increase the maximum annual amount of earnings to which payroll taxes are applied.

(18) The White House (2005), p. 1.

(19) L. Randall Wray, "Killing Social Security Softly with Faux Kindness," Policy Note 2001/6, The Levy Economics Institute of Bard College, Annandale-on-Hudson, NY, 2001, p. 1.

The starting point of the debate is the 75-year annual actuarial forecast released by the Board of Trustees. According to the Board's 2005 report, there are two important dates:

- 2017: the anticipated date when the trust funds will run a cash deficit; and
- 2040: the anticipated date when assets in the trust funds will no longer cover the full cost of scheduled benefits.

Although three cabinet members are on the Board, its forecasts are generally accepted as unbiased and competent. Granted, there are others who argue that long-range forecasts are inherently uncertain and that the assumptions used in these particular forecasts are overly pessimistic.(20) These analysts argue that a small change in any of the variables underlying those assumptions – the predicted growth in U.S. productivity, projected trends in the economy and the changing ratio of workers to beneficiaries – will have substantial and compounding effects on long-term forecasts.(21) However, notwithstanding the differences in assumptions used by forecasters, the weight of evidence suggests that within the next 10 to 20 years the trust funds will indeed run a cash deficit if there are no changes in scheduled tax rates and benefits.

The Board predicts that in 2017 the federal government will have to borrow (issue bonds), raise taxes, or reduce spending on other programs to meet scheduled benefit commitments. This prediction raises the question of why the government would have to take such measures in 2017 when the assets in the trust funds are forecast to cover the full cost of scheduled benefits up until 2040. The answer is that the substantial assets in the trust funds are made up of Treasury Bills, which amount to the federal government owing itself. Essentially, the federal government is borrowing from the surplus revenue in the Social Security trust funds to pay for today's government programs, and promises to reimburse those funds when the debt comes due.(22) The debt will start to come due in 2017.

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(20) Dimitri B. Papadimitriou and L. Randall Wray, "Can Social Security be Saved?" Working Paper No. 270, The Levy Economics Institute of Bard College, Annandale-on-Hudson, NY, May 1999.

(21) Indeed, the Congressional Budget Office released its own actuarial report and the results indicate solvency up until 2052. Some economists have re-forecast the long-term financial solvency of Social Security based on assumptions contained in the federal budget and found that the trust funds would last until 2065. See also Brian Roach and Frank Ackerman, "Securing Social Security: Sensitivity to Economic Assumptions and Analysis of Policy Options," Working Paper No. 05-03, Global Development and Environment Institute, Tufts University, Medford, MA, May 2005.

(22) In light of this situation, one might argue that the Social Security program cannot truly be deemed insolvent in isolation from the entire federal budget.

How will the federal government fund the cash shortfall expected in 2017? The Bush administration argues that the future ratio of workers to beneficiaries will be insufficient to fund Social Security to an extent that would make it an attractive option for future contributors. Accordingly, personal savings accounts are proposed as a way of maintaining the viability of the program into the future.

B. Personal Savings Accounts

A central element of the Bush administration's Social Security strategy is to replace part of the existing pay-as-you-go program with personal savings accounts. Many details remain to be defined, but generally it is proposed to divert part of the payroll tax into personal accounts. A participant's Social Security entitlement would be reduced upon retirement by the amount that has been diverted into his or her personal account plus the interest that would have been earned within the trust funds.

Investments in the accounts would be restricted to broad-based, conservative investment funds with safeguards to ensure that as participants approach retirement, their investment would move towards more secure assets to avoid sudden swings in value on the eve of retirement. Those who choose not to establish a personal savings account would continue to draw benefits from the traditional (but reformed) Social Security system. Personal savings accounts would be transferable and inheritable. A minimum amount might be designated for annuity withdrawals;[23] only money not annuitized would be inheritable. The following section explores the major issues associated with personal savings accounts.

1. Ownership

Competing ideological principles are at the core of the debate over personal savings accounts. Those who favour such accounts want to increase individual responsibility, ownership and control over Social Security contributions. Those who reject them favour collective responsibility and the sharing of costs and risk.

Supporters of the proposal argue that, by engrafting a concept of accrued property rights to Social Security contributions, personal savings accounts would protect future retirees

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(23) White House Office of the Press Secretary, "Background Press Briefing on Social Security," 2 February 2005.

from possible ad hoc changes to program benefits by future governments. Also, the ability to bequeath unused[24] portions of personal savings accounts would provide more control over the intergenerational transfer of wealth.

These features, however, come at the expense of increased risk of outliving one's assets. The creation of personal savings accounts will diminish the amounts currently available for collective annuities. Those who die early will contribute less to the collective pot. If this situation results in lower overall benefits, then lower-income earners may lose out since the current structure is designed to redistribute income: "benefits replace a smaller portion of earnings for higher earners and a larger portion for lower earners."[25]

2. Investment

The revenues in personal savings accounts would be invested in broad-based investment funds that are predicted to yield higher rates of return than the Treasury Bills in which Social Security contributions are currently invested. Some have argued that the yields could grow sufficiently to cover future benefit commitments, thus averting the need for dramatic benefit cuts or payroll tax increases.[26]

Those who oppose the concept of personal savings accounts argue that they would increase participants' pension risk at a time when many corporations are moving away from defined pension plans.[27] For many workers who already own stocks or other investment vehicles through 401(k) plans (so named after the section of the Internal Revenue Code that authorizes this kind of plan) or Individual Retirement Arrangements (IRAs) – two popular options for retirement savings in the United States – having personal savings accounts within the Social Security framework would add little to their existing ability to diversify their portfolios.

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(24) It is often argued that low-income participants, who typically have difficulty accumulating wealth, would benefit from the ability to bequeath Social Security contributions. However, according to senior administrative officials, the inheritability would not apply to the full amounts accumulated in personal accounts. Upon retirement, certain participants would be required to receive a minimum-level annuity set at the poverty income level. Only money not committed to an annuity could be left as an inheritance. It is likely that low-income participants would not have accumulated substantial amounts above the minimum-level annuity – a situation that undermines the claim of wealth/bequest advantages for low-income people.

(25) Douglas Holtz-Eakin, Director of the Congressional Budget Office, Testimony before the Committee on Finance, United States Senate, 25 May 2005.

(26) Martin Feldstein, "Structural Reform of Social Security," *Journal of Economic Perspectives*, Vol. 19, No. 2, Spring 2005, pp. 33-55.

(27) Diamond and Orszag (2005).

Investment in stocks within the program might be attractive to some workers who have few assets outside of Social Security, but it would come at the cost of increased risk.

There are concerns that the investment industry would benefit from investment management fees and other charges at the expense of the average worker. Proponents of personal accounts argue that administrative costs would be low due to economies of scale: there would be a centralized administrative structure and a limited range of broad-based investment options. It is further argued that most of the administrative costs (e.g., record-keeping) would be borne by the government.

3. Transition Costs

As part of payroll taxes would be diverted to individual savings accounts, there would be less money to honour the Social Security program's existing benefit commitments. This would accelerate the exhaustion of the trust funds and advance the date at which the program would show a cash deficit. Therefore, the federal government would be required to borrow additional funds in the short term to finance the transition to personal savings accounts. The amount of transition financing required is estimated at $664 billion over the next 10 years ($754 billion, including interest).[28]

Some have argued that the transition costs make it impossible to introduce personal savings accounts in a manner that does not impose an inequitable burden on the transition generation. Others, however, believe that a fair and gradual transition is manageable.[29]

C. Addressing Social Security's Actuarial Deficit

The debate over personal savings accounts has eclipsed much of the discussion concerning ways to address the Social Security program's actuarial deficit. However, it is generally believed that personal savings accounts by themselves would not resolve the problem.

The actuarial deficit could be addressed in a number of ways. Notably, the government could either increase program revenue or decrease benefits. It could also seek higher returns from the trust funds by investing in the stock market instead of Treasury Bills. Other options include policies that increase the ratio of workers to retirees, such as policies

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(28) The White House (2005), p. 8.

(29) Feldstein (2005).

designed to encourage the migration of a younger work force from other countries, or to enhance worker productivity and economic growth.

1. Increase Revenue

There are a number of options for increasing revenue to the program. The payroll tax rate of 12.4% could be raised, as could the maximum annual amount subject to that tax. The tax base could be expanded to include current exceptions such as university students with part-time employment earnings, employment fringe benefits and employment sales incentives.[30]

There is some resistance to increasing payroll taxes, since they are considered regressive: they are applied only to earned income and not to dividend, interest or capital gains income, which are mostly associated with wealthier citizens.[31] Also, the restriction on the maximum amount of earnings subject to the payroll taxes contributes to that regressiveness, particularly since the percentage of aggregate earnings that is above the maximum ($90,000 in 2005) has risen over the past two decades. There is a concern that an increase in payroll taxes, at least in the short run, would increase the cost of employment for businesses and thus increase unemployment. It has also been suggested that increasing payroll taxes would reduce the payroll tax base, since employers and employees would seek alternative forms of remuneration, such as fringe benefits, to avoid the additional tax burden.

An alternative option would be to fund Social Security from revenues outside the payroll taxes, for example through broad-based taxes such as income taxes. Supporters of this option justify it by pointing out that the annual surplus accumulated in the trust funds has been used as general revenue to provide for programs outside the Social Security system.

2. Decrease Benefits

Benefit reductions could improve the program's actuarial balance, but they would also reduce the income replacement rate (the percentage amount by which the annual benefit is intended to replace lifetime average annual earnings). Such a reduced rate could threaten the viability or relevance of the program.

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(30) George K. Yin, Chief of Staff of the Joint Committee on Taxation, Testimony at a hearing of the Senate Committee on Finance on "Social Security: Achieving Sustainable Solvency," 25 May 2005, http://www.house.gov/jct/x-38-05.pdf.

(31) The regressiveness of the Social Security payroll taxes is mitigated by measures such as the Earned Income Tax Credit, which reduces income tax liability for low-income workers.

Although Social Security benefits are linked to the level of contributions, the program's structure is designed to redistribute income.[32] Lower-income participants receive higher replacement rates than higher-income participants, due to the cap on covered earnings. Therefore, all else being equal, a base reduction in benefit amounts would have a larger impact on lower-income people.

The benefit payout is structured in the form of an annuity from the day the participant retires to the day he or she dies. If, through innovations in health, medicine and nutrition, participants live longer, then program costs increase. Some have proposed that a combination of benefit reductions and payroll tax increases be used to compensate for the additional costs to Social Security from the increase in life expectancy.

Another option would be to change the indexation factor applied to benefits. Moving from the current wage indexation to price indexation would reduce the cost of the program, since prices rise less rapidly than wages. The compounding effect on future benefits would be substantial. Some have proposed moving to price indexation for most benefits but retaining wage indexation on benefits for low-income retirees.

D. The Need for Political Consensus

The Democrats have stated that they will not agree to proposals that include personal savings accounts. The Bush administration has strongly endorsed personal savings accounts as an integral part of the Social Security solution. However, public support for major changes to Social Security has been difficult to secure.

Two committees are holding hearings and considering legislation dealing with Social Security reform: the House of Representatives Ways and Means Committee – Subcommittee on Social Security; and the Senate Finance Committee – Subcommittee on Social Security and Family Policy. It is generally accepted that a bipartisan agreement must be reached before legislation can be approved. In 1983, Republicans and Democrats agreed to a combination of benefit reductions and a payroll tax increase. At that time, however, the debate was considerably more time-sensitive; an agreement was reached just two months before the trust funds were to run out of cash.

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(32) Holtz-Eakin (2005).

THE CANADIAN EXPERIENCE

Similar to Social Security in the United States, the Canada Pension Plan (CPP) is a mandatory, contributory social insurance pension system. The CPP is financed through payroll taxes (applied equally to the employer and employee) and provides retirement benefits for workers and their families. Unlike Social Security, which is uniquely a federal program, the CPP is jointly stewarded by the federal and provincial governments.(33) Both Social Security and the CPP protect workers from a loss of income due to disability, and both programs are designed as pay-as-you-go pension systems whereby current workers pay for today's retirees.(34) The overall retirement system in both countries promotes voluntary savings by providing tax incentives such as Registered Retirement Savings Plans (RRSPs) in Canada and 401(k) plans in the United States.

Although this paper does not extend to a comprehensive comparison between the two social pension systems, it is worth noting that Canada, unlike the United States, offers a minimum flat-rate monthly pension – the Old Age Security (OAS) – to persons aged 65 and older which is funded through general revenues. Employment history is not a factor in qualifying for the OAS, but there is a minimum residency requirement. The OAS is diminished if the recipient's net income exceeds a certain amount ($60,806 for 2005). The OAS is topped up by the Guaranteed Income Supplement (GIS) for seniors with low incomes.

Like the United States, Canada faces demographic challenges to its public pension system. Canadian baby boomers are starting to retire and the ratio of workers to retirees is diminishing. In the years ahead, workers will have to fund escalating public pension benefits, since there will be fewer younger workers to contribute to the system than in previous generations.(35)

Similar to the current debate over Social Security in the United States, Canada began a public discussion in the mid-1990s on the future financial challenges facing its public

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(33) Quebec has a parallel pension insurance program, the Quebec Pension Plan (QPP).

(34) With the establishment of the CPP Investment Board, this is less the case today in Canada than it would appear to be in the United States.

(35) Further, Canada's productivity growth has historically trailed that of the United States, which acerbates the problem for Canada. See the OECD Web site, *Productivity*, http://www.oecd.org/topicstatsportal/0,2647,en_2825_30453906_1_1_1_1_1,00.html.

pension system.[36] Actuarial estimates[37] at that time predicted that the CPP reserve fund would be exhausted by 2015, suggesting that federal and provincial governments would need to increase the existing 1996 combined payroll tax rate from 5.6% to 14.2% by 2030 to maintain scheduled program benefits.

By 1997, reforms to the CPP were approved by the federal government and enough provinces to meet statutory provisions for change.[38] Key factors in the CPP reforms were a broadening of the tax base[39] by freezing the annual taxable earnings exemption at $3,500 (normally it would grow with inflation) and an accelerated increase in the scheduled payroll tax rate to reach and maintain the estimated steady-state financing rate of 9.9%, the lowest rate necessary to fund future liabilities.[40] The revenue adjustments coincided with an increase in the reserve fund to cover five years of benefits as opposed to the previous coverage of two years, making the program more fully funded and less "pay-as-you-go."

The 1997 reforms reduced benefits, and eligibility was tightened through a requirement for increased workforce attachment, particularly for disabled recipients. A new investment policy was developed that led to the creation of the CPP Investment Board, an organization at arm's length from government that is charged with seeking higher rates of return on the reserve funds by investing them in a diversified portfolio of securities. Previously, reserve funds were invested in non-marketable securities of provincial governments. It is estimated that a proportion of CPP investment earnings will be required to fund benefits in 2022 and beyond.

By contrast, in the United States, the Social Security trust funds are made up of Treasury Bills; they do not represent real assets, but IOUs that the government promises to pay. In 2017, the federal government will have to honour these IOUs because the revenue from the payroll tax will not be sufficient to cover the cost of benefits. As discussed earlier in this paper, this looming fiscal burden has framed much of the debate on Social Security in the United States.

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(36) Federal, Provincial and Territorial Governments of Canada, *An Information Paper for Consultations on the Canada Pension Plan*, Department of Finance Canada, February 1996.

(37) *Canada Pension Plan: Sixteenth Actuarial Report*, September 1997, http://www.osfi-bsif.gc.ca/ app/DocRepository/1/eng/oca/reports/CPP/cpp16_e.pdf.

(38) *Securing the Canada Pension Plan: Agreement on Proposed Changes to the CPP*, Department of Finance Canada, February 1997.

(39) Mark Sarney and Amy M. Preneta, "The Canada Pension Plan's Experience with Investing Its Portfolio in Equities," *Social Security Bulletin*, Vol. 64, No. 2, 2001/2002.

(40) The rate has since been reduced to 9.8%. The steady-state rate will vary depending on demographic considerations and the economy. The program is sustainable as long as the steady-state rate is below the actual rate.

A comparison of the finances of Canada and the United States has found that the U.S. federal finances and public pension system are not sustainable without tax increases or expenditure reductions, while in Canada "the federal government and the CPP/QPP are sustainable over the long term."(41)

CONCLUSION

Social Security in the United States was born in the Depression era and has grown to be one of America's largest federal spending programs. More than nine of every ten seniors in the United States receive some form of Social Security payments. However, due in part to the growing number of retirees (the baby boomers), Social Security payments are expected to exceed contributions by 2017. At that point, even though the Social Security trust funds will not be depleted until 2040, the federal government must borrow more money, raise payroll tax revenue, reduce Social Security benefits, or reduce other program spending to fund the cash deficit.

The actuarial imbalance has precipitated the notion of a crisis within the Social Security system – a view that is not unanimously shared across the political spectrum. Nevertheless, the Bush administration has made Social Security reform a domestic priority and has proposed the use of personal savings accounts as a key component of the reform solution. These accounts would replace part of the existing "pay-as-you-go" feature of the Social Security system; the proposal is strongly opposed by some observers.

Like the United States, Canada faces reductions in the ratio of workers to retirees, which places pressure on the CPP. However, Canada negotiated CPP reforms in 1997 that included payroll tax increases to more fully fund the CPP, benefit reductions and a more aggressive investment strategy. Moreover, a key difference between United States and Canada is that the CPP investment fund is managed by an arm's-length agency and the assets in the fund can be drawn down without the federal government's incurring additional debt.

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(41) Suzanne Kennedy and Chris Matier, "Comparing the Long-term Fiscal Outlook for Canada and the United States Using Fiscal Gaps," *Department of Finance Working Paper, 2003-2004*, August 2002.