It [Social Security] cannot remain static. Changes in our population, in our working habits, and in our standard of living require constant revision.
President John F. Kennedy, June 30, 1961.

Introduction

Since President Kennedy made that remark, real per capita income has tripled, the life expectancy of the elderly has increased 20%, the typical retirement age has declined to 62, the ratio of taxpayers to benefit recipients has plummeted 35%, fertility rates have fallen, the fraction of American families owning equities has doubled to 50%, and the poverty rate among the elderly has fallen by two-thirds to below that of the non-elderly.

Looking to the future, the life expectancy of the elderly is projected to rise another four years in coming decades, the aged-dependency ratio is projected to more than double in this period, and the Social Security system faces a long-term projected shortfall of roughly $11 trillion in present value if—and it is an extreme and unlikely if—the current benefit formula were carried forward into the indefinite future.

Thus it would be shocking—really shocking, not Claude Rains in *Casablanca* shocking—if it made sense to continue a system designed in the Depression that matured in the post-World War II era under vastly different economic, demographic and financial conditions than exist today or will exist in coming decades, exactly in its current form, decade after decade for at least another seventy-five years.

So President Bush, like President Clinton before him, proposes to resolve Social Security's long-term solvency problem. And, like the late Senator Daniel Patrick Moynihan, for decades the intellectual leader of the Democratic Party on social insurance issues, he proposes to modernize Social Security with an individual account component. Bush is trying to do something democracies have always struggled with: dealing with long-run problems before they become a crisis, absent immense short-run pressure (the last major Social Security reforms were passed in 1983 under pressure that Social Security checks might have had to be delayed).

It is thus disheartening that the idea of dealing with Social Security's impending financial insolvency and the individual accounts proposal have caused the President's political opponents to become virtually unhinged. The attacks have been of a ferocity and hyperbole that used to be confined to the period immediately prior to presidential elections, and then usually done below the radar screen. The critics declare that the President's proposals (thus far, a general set of ideas, not specifics) will break promises, undermine Social Security, and destroy the social fabric. Let's get real. Individual accounts are hardly the 21st century equivalent of Attila at the gates of Rome. Nor are they a magic answer to the long-run solvency of Social Security. But, done properly, in combination with sensible reforms to address solvency, they are an excellent idea on their own merits.

By far the most important issue is to put in place, sooner rather than later, reforms that gradually and cumulatively bring projected future benefit growth in line with projected future revenues without a tax increase. Waiting several decades to deal with the issue raises the prospect of a 50% increase in payroll taxes, a giant step toward a European-style social welfare state and its concomitant economic stagnation, double-digit unemployment, and socioeconomic ossification. Alternatively, benefits then could be cut abruptly, which would be wrenching for future retirees' finances.

Two Myths About the Cuts in Guaranteed Benefits: "Cuts" and "Guaranteed"

Perhaps the best place to start a rational discussion of these issues is to straighten out the language used to describe Social Security and the proposed reforms. When is a contribution really a tax? A trust fund, nothing of the sort? A promise, a mechanical and unsustainable projection? So-called current law projections, a violation of current law? A guarantee, almost certain not to be realized? And a cut, actually an increase? These misappropriations of language obfuscate the facts about Social Security.

The critics claim there will be massive cuts in guaranteed benefits. This is not only misleading; it is absurd. In contrast to the conventional spin, nobody's benefits need to be cut and nobody's taxes need to be raised. Current tax rates, given projected economic growth, are sufficient to deal with the demographic deluge.[1] The current benefit formula, as carried forward in the long-term Social Security projections, implies real Social Security benefits per recipient will double in the next few decades. This occurs because: 1. The formula used to calculate the initial level for a retiree's Social Security benefit indexes historical covered earnings to wages rather than prices; since wage growth generally

[1] Or with doubling real benefits, but not both.

exceeds price growth, future benefits rise by roughly the rate of productivity gains. From 1960 to 2004, the average wage index in covered employment rose 1.1% per year faster than consumer prices as measured by the Consumer Price Index (CPI).[2] 2. People will be living longer, which increases the present value of total lifetime Social Security benefits.[3] 3. The change in the Consumer Price Index, which indexes Social Security benefits post-retirement, overstates inflation[4] by 80-90bp/year despite some valuable improvements made by the Bureau of Labor Statistics (30 or 40bp of this bias would be eliminated if and when the BLS moves to its far more accurate chained-CPI as the official measure of consumer inflation).[5]

The claims that guaranteed benefits will be cut and promises broken are relative to projecting the current benefit formula forward indefinitely. This is misleading on several counts. The Social Security Administration sends future beneficiaries an annual statement which clearly states that the current system cannot pay such benefits; in a few decades, under current law, there will only be 74 cents in taxes coming into the Trust Fund, from which benefits must be paid, for every dollar of projected benefits. Further, Congress has often changed benefits in the past, most recently by taxing them, and is certain to do so in the future. The Supreme Court has ruled no one is entitled to the benefits; they are not legally owned assets. In fact, most younger workers are not expecting to receive them. There is thus nothing “guaranteed” about the benefits; they involve immense economic, demographic and political risk.

Clearly there is a continuum in any notion of political promises: current retirees and those soon to retire have based their finances on the current Social Security system, whereas younger workers and those not yet working have done much less, if any, planning for retirement and do not expect to receive the benefits in current projections. Thus whatever political promises are deemed to exist have,

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[2] To take a simple example, someone retiring in 2003 whose 1989 earnings in covered employment were $20,100, would have that year’s wages indexed up to $34,065 in 2003, a cumulative 22% more than prices, and likewise for other years. The initial Social Security benefits (called the primary insurance amount, or PIA), are a (progressive) function of the average indexed monthly earnings (AIME).

[3] The Social Security Administration Trustees (2005) project that the life expectancy of the elderly will rise four years in their “intermediate” cost scenario. Many experts think it will increase even more, although recent concerns about obesity and a range of other potential problems may dampen that optimism.

[4] On the change in the CPI overstating inflation, see Boskin, et al. (1997) and LeBow and Rudd (2003).

[5] A “basis point”, abbreviated “bp”, is one one-hundredth of a percent. Hence, the overstatement of inflation is about 0.8 or 0.9 percentage point.

and should have, great force for older workers and near-retirees, less force for middle-aged workers, and little force for younger workers.

Let's examine this notion of benefit "cuts" and broken "promises" more closely. The President has stated that nobody who has already retired will have any changes whatsoever, nor will those near retirement, defined as those 55 and over. No cuts or broken promises there. The most widely discussed proposal, that of indexing by prices rather than wages, would still leave ample room for substantial benefit growth for people in mid-career, via life expectancy rising more rapidly than retirement ages and by the price index, even after shifting to the chained CPI, overstating inflation. As for younger workers, they consistently state when surveyed that they do not expect to receive any Social Security benefits; they expect the system to be bankrupt and gone by the time they retire. This, of course, is exaggeration; there will and should be a Social Security system when they retire, although it will change somewhat from the system now in place. It is bizarre to call slower increases relative to today's levels a cut for people who expect nothing at all. Ditto for people not yet in the labor force. Ditto for those not yet born. Only in Washington would higher real benefits in the distant future, for people who do not expect to receive them, be considered a "benefit cut". Or a mechanical projection of a benefit formula put in place in 1977, a 2005 promise of benefits in the year 2080 to the not yet born.

Attaining Solvency: Part A of Reform

There is an obvious set of commonsensical reforms which would strengthen and modernize Social Security, improve incentives, and eliminate the drag the uncertainty over future funding causes for families and the economy. First, we should switch from wage indexing to price indexing, but raise benefits more rapidly for low earners below the poverty level. This would eliminate most of the long-term insolvency, but do so in a manner that leads to rapidly rising real benefits for people with low incomes, and more slowly rising real benefits for people with higher incomes. Next, we should prospectively increase the retirement age in several decades slightly beyond that in current law, while maintaining a strong early retirement option. Combined with a somewhat more accurate CPI (the BLS—not the Congress—implementing its vastly superior chained-CPI), these reforms will deal with the long-run solvency issues. And they will finally fully deliver what is Social Security's most important mission, as stated at its inception by President Franklin D. Roosevelt, providing “the average citizen protection against poverty-ridden old age.”[6]

There is a strong economic, not just budgetary, reason why it is not sensible to carry a benefit formula deriving from an age of vastly different demography, economics, and household finance, into the indefinite future. Economists use a term called the diminishing marginal utility of income to express the commonsense notion that as we get richer, the incremental value of yet more income declines. For example, some income is necessary for survival, e.g. to buy food, so it has immense value. At the other extreme, a second home may be valuable to a family, but not so much as their first home, let alone food for survival. Thus, providing insurance via Social Security against destitution in old age, say at the poverty line, is extremely valuable; insuring the next level of income, publicly or privately, is less, but still valuable, and as benefits go higher and higher, the incremental value of providing a government guarantee of the income declines. So keeping a constant ratio of government benefits to income, decade after decade as real incomes double, is unnecessary.

Individual Accounts: Part B of Reform

Finally, we should add an individual accounts component to Social Security, call it Part B, whereby younger workers can put a modest portion of their payroll taxes up to a limit into a broadly diversified, low-cost index fund. When funds are withdrawn, there would be a partial offset in traditional Social Security, thus keeping the sum of the two systems in long-run balance.[7] Like the other reforms, individual accounts should be phased in gradually over time. There is an especially strong case for individual accounts for the half of the population that owns virtually no assets. Just as we are better off as a society of home-owners, we are also better off if virtually everyone in the population is an investor as well as a worker, consumer and eventual benefit recipient.

Many critics of individual accounts denounce the idea of borrowing to finance them. While I share concerns about large deficits in prosperous peacetime, there is a fundamental difference between borrowing to finance individual accounts and borrowing to fund general government consumption. That borrowing passes the bill for paying for the current generation’s

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[6] The official poverty level is indexed for inflation by the change in the CPI. It rises with prices, not wages.

[7] See the President’s Advisory Commission on Social Security Reform (2001) for detailed discussion of offsets.

consumption to future generations. This is why many people consider deficit finance "bad". However, the individual accounts acquire real assets. So, while there is borrowing by the government on the one hand, it finances investment in real assets on the other, like borrowing to buy a home, not to throw a party. Suppose we call individual accounts Part B of Social Security. Then, if the federal government, like private businesses, kept separate capital and operating budgets, they would show no change whatsoever in the operating budget balance. In short, while the government borrowing passes liabilities to future generations, assets are passed as well. So there is no net intergenerational transfer.[8] Is there really such an aversion to private capital that only government spending counts?

The proponents of individual accounts rely on arguments of a substantial increase in saving, improved economic performance, higher returns from some of the funds being invested in equities, etc. These arguments are correct, but not without caveat. Not everyone will save more. Some people will adjust their other saving, so the full amount of saving in the individual accounts will overstate the total amount of incremental saving. However, working in the opposite direction is the fact that it will be much harder for the government to get its hands on the funds and spend them, as it has done repeatedly with Social Security surpluses for decades under administrations and Congresses of both political parties. Thus, in this sense, individual accounts may be more, rather than less, likely to increase national saving. The equity argument is correct in expected value, but clearly the excess returns to equities are payment for taking on added risk, although that risk is mitigated considerably by the required broad diversification in index funds and the long-term nature of the investment. Thus, the fact that up to half the population has no financial assets, let alone equities, suggests there will be some incremental saving and some risk-adjusted returns above and beyond what would be expected from the notion that individuals would offset their individual account investments by adjustments in the balance of their portfolios.

The biggest concern with individual accounts is one its opponents seldom raise: the growing future political power of the elderly may eventually result in at least a partial cancellation of the offset against individual account income, thereby turning the debt financed ex ante "carve out" subsequently offset by traditional Social Security into an ex post "add-on" financed by taxes on future workers.

Thus, think of the reform as consisting of two parts: A. Deal with long-run solvency by partial price indexing, slightly increasing the retirement age in the

[8] Actually, as noted below, the borrowing to finance individual accounts and then offsetting part of the retirement income from individual accounts with less traditional Social Security can make future generations of retirees better off.

distant future, and a modest, overdue BLS improvement in the consumer price index. B. Modernize Social Security by adding an individual account component. Nobody gets their benefits "cut" from part A. It is very unlikely that adding part B will lead to benefits being less than they would have been if the system described in part A—call it the sustainable traditional Social Security system—had been in place. It is likely that most younger workers will eventually receive more from the sum of their individual account income and traditional Social Security than they would in the end have received from the unsustainable current system. It is true that there is a remote possibility that there might be some individuals, even in broadly diversified mutual funds invested for a long time, whose returns could be less than if the investment had been in very safe assets, such as Treasuries. But, even in the remote possibility that the benefits would be less, they are almost certain to be only slightly less. Note, however, that some opponents report just the "guaranteed" benefits, implying that the entire investment would be wiped out, and then compare that absurd result to projections of the current system which are not guaranteed, are not financed under current law and are not even expected by young workers.

Put the other way around, suppose we have the Social Security reform described above in Part A (partial price indexing, slightly higher retirement age, more accurate CPI) in place. Does anyone really believe it would make sense to double the benefits for future retirees in coming decades and finance the expansion with a 50% increase in the payroll tax, especially given the impending larger financial problems in Medicare? That is what the opponents of Social Security reform are really peddling. Keeping the current system in place and raising taxes later just taxes future workers to pay ever larger inflation-adjusted benefits to well-off future retirees, prevents the bottom half of the wealth distribution from owning assets, and eventually wreaks havoc on the economy.

Bad Ideas from the Left and the Right

There are (at least) two terrible ideas being floated in the reform debate, one from the left and one from the right, that in the long run paradoxically might facilitate outcomes desired by their political opponents. First, raising or removing the cap on the amount of earnings subject to payroll taxes for Social Security would greatly increase the marginal tax rate on the most productive group in the population. This would undo all the good and then some from the President's reduction in marginal income tax rates. Second, such a move would end any presumption that the Social Security system is an insurance system. The current $90,000 tax cap was not chosen arbitrarily; benefits are paid on taxable earnings up to that limit. Whenever the cap has been raised before, additional benefits were paid on the taxed earnings— taxes are called "contributions" although they are not voluntary—up to the new cap. Severing the link between benefits and taxable earnings would be a huge conceptual step, making the tax/transfer, or welfare, component of Social Security far more explicit. This risks its political support, which has been predicated on it being viewed as social insurance, not welfare. There is far more at risk for those who favor social insurance in this step than adding an individual account component to the system. But even more fundamentally, why would we want to raise taxes on well-off workers to fund higher benefits to well-off retirees? If there is an argument that the Social Security system should be made even more progressive, it is far more properly focused on the benefit side rather than the tax side.

Second, some proponents of individual accounts argue for issuing government recognition bonds for the massive unfunded liability. They argue this just makes implicit promises explicit. If recognition bonds were a much smaller amount and if we thought people had expected the bulk of the extra benefits they make explicit, it might make sense to run a small-scale experiment, because the risk of being wrong was low and the consequences small. But that is not the case. Further, younger workers continually say that they do not expect to receive any Social Security benefits when they retire. So it is likely that a considerable fraction of the bonds would be unexpected, and the large increase in perceived wealth might result in an inflationary spending boom. Making projected future benefits explicit locks in a large, at least partly unnecessary, expansion of government to the detriment of the economy.

Why Act Now?

A favorite question of critics of reforming Social Security is: Why act now, when there is no problem, let alone crisis? Just as time is not on our side in dealing with terrorists in an age of weapons of mass destruction, so it is not on our side in the demographic transition which threatens to destabilize the political economy of taxes and spending. The first baby boomers will begin to retire in three years. The fraction of voters receiving benefits will increase 50% in 20 years, and double in 50, relative to the fraction of voters paying taxes, making reform ever more difficult. And, once delayed, reform is ever more likely to lead to vastly higher taxes without slower benefit growth.

Reform is long overdue and should be implemented gradually and cumulatively after a grace period. That way, by the time the demographics really bite in two or three decades, the solvency problem is solved and families and the economy have time to adjust gradually without severe disruption. If we wait and make changes abruptly, with gigantic tax increases or benefit cuts or some combination all at once, wrenching adjustments would be required for beneficiaries, taxpayers, and the economy. Thus, reform really is urgent. Enacting these sensible reforms now would strengthen the economy, spare future retirees and taxpayers disruption in their personal finances and ensure Social Security plays an important and appropriate role in future retirement income security.

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