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Social Security

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Social Security plays an important role in the lives of senior citizens. Social Security benefits represent an important source of income for most recipients, and an essential one for some; benefits account for more than half of total income for about two-thirds of beneficiaries over age sixty-five. At the end of December 2004, the average monthly benefit for retired workers was \$955, and the average for retired couples was \$1,574. Social Security also affects the nation's finances. On the revenue side, Social Security will collect about \$600 billion in payroll tax revenue in 2005, accounting for more than a quarter of all federal revenue. For 63 percent of families, Social Security payroll tax exceeds income tax liability.¹ On the expenditure side, Social Security's payments this year will exceed \$500 billion, which represents more than a fifth of all Federal outlays.

The primary reason that both Presidents Clinton and George W. Bush have made reforming Social Security a priority is that the system faces a long-term deficit.² Under current law, its benefit payments are projected to exceed payroll tax revenue beginning in 2018, and to exceed total revenue

(including interest paid to Social Security by the rest of the budget) in 2028. If nothing were done, those deficits would become increasingly large over time. The deficits reflect many factors, including ongoing improvements in life expectancy and the low fertility rates of the past forty years (which are projected to persist in the future). Over the next seventy-five years, the actuarial deficit in the program amounts to 0.7 percent of gross domestic product; over an infinite horizon, the actuarial deficit amounts to 1.2 percent of GDP.

Restoring the solvency of Social Security necessarily involves politically painful choices: either revenue increases or benefit reductions, or some combination of both. Unfortunately, too many analysts and politicians have responded to these unpleasant alternatives by desperately trying to avoid them: they either ignore the need to reform the program or embrace “free lunch” approaches that pretend the problem can be addressed through magic asterisks or gimmicks. The public may be confused by such denials of the problem. A recent poll found that about half of Americans favored leaving Social Security “as is.”³ Regrettably for them, “as is” is not an option over the long run. Avoiding real reform either through delay or by adopting a free lunch approach merely exacerbates the painful choices that will ultimately be necessary to restore solvency and honor whatever benefits have been promised.

As the authors of this chapter, we do not agree on several important issues relating to Social Security. For example, we differ on what would be the appropriate mix of tax increases and benefit reductions to restore long-term balance to the program and on whether some payroll tax revenue should be used for individual accounts. We also disagree about the extent to which the Social Security trust fund has raised national saving and therefore represents real wealth available to help future generations. Despite our differences, we agree on many fundamental issues. We agree that it would be better to eliminate the projected solvency problem sooner rather than later, and that reforms should aim to raise national saving and fairly distribute the necessary burden of eliminating the long-term deficit. Perhaps most important, we both firmly reject the false claims of painless solutions to the projected imbalance in Social Security.

Given these areas of agreement and disagreement, the rest of this chapter is organized into three sections. In the next section we propose

objectives for reform of the program. Then, we examine two controversial issues: the economic significance of the Social Security trust fund and the role of individual accounts in reform. Finally, we present and evaluate a menu of options to enhance revenues or reduce obligations. These include, among other possible steps, raising the age of eligibility for collecting full benefits, changing the way initial benefits are determined, and raising the cap on taxable earnings.

Objectives of Reform

Social Security reform necessarily involves a balancing of many competing objectives. In this section, we lay out several key goals for reforming the program.⁴

Objective 1: Reform sooner rather than later. The earlier reform to Social Security is enacted, the more manageable the required adjustments can be: by beginning sooner, it is possible to spread the costs over a longer period of time and ensure that no generation bears an excessive burden. If reform is delayed, by contrast, more dramatic steps will be necessary—including the likelihood of having to make substantial and sudden changes to benefits upon which people had based their retirement plans.

To get some sense of the importance of acting sooner rather than later, consider for illustrative purposes the magnitude of the benefit reductions required to close the entire seventy-five-year deficit solely by reducing nondisability benefits. If benefits were reduced immediately, the required reduction would be slightly less than 15 percent. If the reductions did not begin until 2042, when the Social Security trust fund is projected to be exhausted under current law, the required reduction would be about 30 percent.⁵

These figures actually *understate* the growing problem created by delay, because they assume that all nondisability benefits are reduced—including those for people who have already retired. Substantial benefit reductions for those who are already retired or about to retire, however, are socially undesirable and politically unlikely. President Bush has announced that benefits for those older than fifty-five would not be altered in any plan that had his support. All serious proposals include

such protection. However, this feature, while sensible, means larger benefit reductions for everyone else.⁶

Objective 2: Eliminate the Social Security deficit without gimmicks or magic asterisks. Reform should not only eliminate the seventy-five-year deficit in Social Security, but also ensure that another seventy-five-year deficit is not likely to appear in the near future.⁷ The problem shouldn't simply be pushed into year seventy-six and beyond. Nor should the deficit be eliminated through other gimmicks or magic asterisks. For example, the budget outside Social Security is projected to be in massive deficit as the baby boomers retire and real health care costs continue to rise. In this context, claiming to eliminate the deficit in Social Security with substantial, unspecified transfers from general revenue amounts to a massive "magic asterisk."

Many reform plans also count the higher expected rate of return on stocks relative to bonds as a deficit-reducing measure. Yet most, if not all, of the higher expected return on stocks reflects risk, and failure to adjust for that risk presents a misleading picture of the budgetary and economic impact of stock investments. Plans that simply assume that the higher expected return on stocks will generate resources to close the deficit and ignore the additional risks associated with stocks are deceptive.

Objective 3: Raise national saving. The issue of how generous a Social Security system the nation can afford in the future depends in part on the nation's ability to produce more goods and services in the future. A Social Security burden that appears onerous under one projection of future national income will be less so if national income grows more rapidly. The future size of the economy depends on many factors, but one of the most important is how much Americans save and invest. Higher national saving increases the size of the capital stock owned by Americans, and increases future national income.

There are many ways in which the federal government can increase national saving, and Social Security is just one of these. But one of the stated motivations for eliminating the long-term deficit in Social Security is to raise national saving. This motivation underscores the shortcomings in plans that assume massive transfers from the rest of the budget (more borrowing) or fail to either reduce benefits or increase revenue. Such plans often generate little or no increase in national saving.

Objective 4: Maintain an adequate replacement rate in the form of an inflation-protected lifetime annuity. Social Security exists in large part because of a concern that workers would not otherwise adequately prepare for retirement on their own. Furthermore, benefits are provided in the form of an inflation-protected lifetime annuity, so that individuals do not face the risk of having their benefit levels eroded by inflation or the risk of outliving their assets. Although some changes to the program are necessary, reform should recognize the fact that myopia and imperfect decisionmaking are not going to disappear. For this and other reasons, including the well-being of the elderly, we should not dramatically reduce the replacement rate from Social Security—that is, the share of a worker’s previous earnings that Social Security benefits replace.

Objective 5: Protect the most vulnerable. Social Security has many features that provide relatively larger benefits to the groups with the greatest needs. These groups include surviving spouses, young surviving children, people who have had long careers at low wages, and disabled workers. Social Security reform should include protections for these groups, but they should be targeted as efficiently as possible to relieve hardship at the least cost.

Trust Funds and Individual Accounts

Two key elements of the current Social Security debate are the significance of the Social Security trust fund and the desirability of individual accounts. It is possible to disagree on both of these issues, as the two of us do, for the reasons described in this section.

The Nature of the Social Security Trust Fund

Social Security has been running a cash-flow surplus for the past twenty years and is expected to continue to do so for at least another thirteen years. In short, the system has been collecting more payroll taxes than are necessary to pay current benefits. The excess cash has been turned over to the rest of the government in return for special-issue U.S. government bonds. These bonds earn interest, which is paid by the rest of the government by crediting the Social Security trust fund with more bonds. At

the end of 2004, the trust fund stood at about \$1.7 trillion. No one should doubt the value of these assets; they are backed by the full faith and credit of the U.S. government. They represent the surpluses of the system—the present value of the extra revenue collected compared to expenditures—over the past twenty years.

Economists debate, however, whether Social Security's surpluses and its trust fund represent an accumulation of wealth that will help future generations in any way. The question is, What happened to the payroll tax money once it was handed over to the rest of the government? Was it saved or spent? Some economists have found that the Social Security surpluses allowed the rest of the government to spend more and tax less than it otherwise would have, implying that the Social Security surpluses had no net effect on the overall unified deficit or national saving.⁸ Other economists have reached a different conclusion. They believe that a substantial fraction of the Social Security surplus was used to lower the publicly held debt of the government, thus contributing to national saving.⁹

This difference in view affects one's interpretation of the relative importance of some key dates related to Social Security's finances. The intermediate cost projection from the Social Security trustees suggests that the cash-flow Social Security surplus (that is, the surplus excluding interest paid from the rest of the government to Social Security) will continue to increase as a share of payroll until 2007. The cash-flow surplus then begins to decline rather dramatically as the baby boomers begin to collect retirement benefits in significant numbers. By around 2018, the cash-flow surplus will disappear. However, payroll taxes and interest earned on trust fund bonds will cover all benefits until 2028. At that point, the system will have to begin to sell its stock of special-issue bonds back to the rest of the government. These sales will continue until the bonds are exhausted, in roughly 2042.

Those who believe the trust fund has raised national saving tend to focus on the 2042 date, since the additional saving they believe it has produced will better prepare the nation for the claim on general revenues entailed by interest and principal payments on the trust fund bonds between 2018 and 2042. Those who do not believe that the trust fund has improved national saving tend to focus on 2018, since that is the point at which the program's cash flow turns negative and claims on general revenue begin.

Individual Accounts

Social Security has always featured a pay-as-you-go defined benefit retirement system. By *defined benefit* we simply mean that benefits are determined by formula and not by investment returns. Social Security has a different structure, however, from anything in the private sector. In particular, a defined benefit system in the private sector alters the firm's required contributions in response to changes in life expectancy, investment returns, or work patterns. Under Social Security, by contrast, the contributions (in particular the payroll tax), as well as the payments, are legislated and determined by formula. Social Security thus currently lacks the full built-in flexibility of private sector pensions—even those that offer a defined benefit—although the system is also indexed to various factors that reflect economic developments.

The private sector has been moving at a rapid pace from defined benefit plans to defined contribution plans. Social Security reform recommendations with defined contribution elements, or individual accounts, gained prominence during the proceedings of the 1994–96 Advisory Council on Social Security; since then, many proposals have included individual accounts. Interest in such accounts is probably strongest amongst those who believe that Social Security's cash-flow surpluses have failed to increase national saving. Opposition is strongest amongst those who believe that defined contribution plans and their associated risks do not belong in the core tier of retirement income, especially when the private pension system is also shifting toward defined contribution plans.

There are two ways to fund individual accounts, referred to as *add-on* or *carve-out*. Add-on plans would require contributions over and above the payroll tax used to finance traditional retirement benefits under Social Security. Carve-out plans would divert some portion of existing payroll taxes into individual accounts. An important point is that neither carve-out nor add-on plans are free, from the participant's point of view. The payment for the carve-out plans comes when benefits are subsequently reduced to offset the cost of the revenue deposited into the account. Under Model 2 from the President's Commission to Strengthen Social Security, for instance, those who voluntarily participate in the individual accounts program have their regular Social Security checks reduced by an amount that equals (in expected present value) the amount they diverted

into the account plus interest (at an interest rate of 2 percentage points plus inflation). With add-on accounts, the cost is more immediate and comes in the form of the extra contributions that the participants make. Any returns from these contributions subsequently add to their retirement income.

A feature of carve-out plans, such as Model 2, is that they create a cash-flow problem. Between the time when revenue is diverted into the accounts and when it is “paid back” through reductions in regular benefits, the program has less money available to pay the benefits of those currently retired. To be sure, the combined effect of the individual accounts and the benefit changes unrelated to the accounts under Model 2 is a surplus within Social Security in 2058 and beyond. But the plan nonetheless raises public debt for about six decades, because the negative cash flow from the accounts dominates the positive effect from the benefit changes for an extended period. Economists hold different views regarding the degree to which the extra borrowing during this transition period would drive up interest rates or pose fiscal risks.

According to their advocates, add-on accounts are the most promising way to increase national saving. This would be particularly true if participation were mandatory rather than voluntary. Some participants in an add-on system, whether mandatory or voluntary, would reduce other forms of saving, so the net addition to private saving would be considerably lower than the total contributions to the plan. It is impossible to predict exactly the extent of such offsetting, but it is likely to be a higher share of contributions under a voluntary system than a mandatory one.

On the issue of risk, we agree with each other and with most other economists that individual accounts invested in publicly traded stocks and bonds would be risky. However, especially in the absence of reform, traditional Social Security benefits also carry risks. Currently promised benefits are underfunded and are likely to be reduced in one way or another. In addition, even an actuarially balanced system could still be affected by uncertainties surrounding future rates of fertility, mortality, immigration, and productivity.

Proponents of individual accounts argue that people can choose how much risk to take. They also like the fact that the balances in such

accounts can be bequeathed. Opponents of individual accounts argue that the foundation of retirement income is not the place to take inappropriate risks, and that the accounts could be burdened by high administrative costs. They also note that the defined contribution nature of accounts could create political pressures to allow pre-retirement withdrawals or less than full annuitization upon retirement.

Individual accounts by themselves will not reduce the underlying deficit in Social Security. Either benefit promises under the current system have to be reduced or additional revenues identified. Add-on individual accounts are actuarially fair, by definition: they are self-financing and do not generate any surplus money to help meet existing Social Security promises. Carve-out individual accounts can also be designed to be roughly actuarially fair (as under the Bush administration's proposal in 2005, which slightly modified the proposal from the President's Commission to Strengthen Social Security); such actuarially neutral accounts neither increase nor reduce the projected deficit over an infinite horizon. The only indirect way that individual accounts could help address solvency is by somehow making reductions in traditional Social Security benefits more politically acceptable. An add-on individual account, in particular, would increase the retirement resources of participants and possibly make it more acceptable to reduce traditional Social Security benefits; of course, the add-on accounts also mean that workers must contribute more to their own retirement. If these contributions were mandatory, many observers (likely including the official budget scorers) would call them a tax.

It is worth noting that many opponents of carve-out accounts strongly support individual accounts in the form of 401(k)s and IRAs. That is, they believe that such accounts have a critical role to play in filling the hole between the foundation provided by Social Security and a comfortable retirement. These economists argue that although individual accounts make sense on top of Social Security, they do not make sense as part of the core retirement income provided by the program. Within that core, benefits should continue to be provided in a form that is protected against inflation, does not fluctuate with the stock market, and lasts as long as you are alive.

A Menu of Options

We have tried to state the problem as simply as possible. Over the long run, Social Security does not have enough revenues to meet its promises. The 2004 trustees' report for Social Security estimates that the present value of benefits exceeds the present value of receipts (plus the trust fund) over the next seventy-five years by 1.89 percent of the present value of the payroll tax base ("covered payroll"). They also estimate that the revenue shortfall at the end of the seventy-five-year period, in 2078, will be 5.91 percent of covered payroll. In other words, it would take roughly a 6 percent of payroll increase in revenues or a similar reduction in benefits to achieve solvency in that year. As already noted, we believe the goal should be to achieve financial balance over the next seventy-five years and to avoid the rapid appearance of another seventy-five-year deficit, which requires avoiding significant deficits at the end of the seventy-five-year period. Table 3-1 lists the measures we discuss below and their percentage contribution toward achieving these goals.

Reducing Promised Benefits

There are obviously numerous ways to reduce retirement benefits. We focus on those that take effect gradually, since we think that is both socially and politically desirable.

I. INDEXING INITIAL BENEFITS BY PRICE RATHER THAN WAGE INFLATION. Currently, initial Social Security benefits increase with average wages in the economy.¹⁰ This means that if wages go up more rapidly than prices over the long haul, monthly retirement benefits increase in real terms. Under the intermediate set of assumptions of the Social Security trustees, people retiring in 2050 would get monthly benefits approximately 64 percent higher in real terms than those of today's retirees, since their lifetime wages would be that much higher. This system generates a constant replacement rate (that is, the share of pre-retirement earnings replaced by Social Security) from one generation to the next under Social Security.

In Model 2 of the President's Commission to Strengthen Social Security, initial benefits would instead be linked only to price increases, not

Table 3-1. *Impact of Alternative Reform Measures on Social Security's Solvency*

<i>Proposal</i>	<i>Percentage improvement in</i>	
	<i>75-year imbalance</i>	<i>75th-year cash-flow deficit</i>
Replace wage indexing with price indexing (president's commission Model 2 without individual accounts)	101	116
Hybrid indexing	71	70
Accelerate increase in full benefit age to 67, index FBA by 1 month every 2 years until FBA = 70	36	29
Increase number of years in benefit calculation from 35 to 40	22	11
Change benefit formula: multiply 22 and 15 percent factors by 0.987 each year, to reduce to 21 and 10 percent in 2035	85	57
Subject 90 percent of earnings to payroll tax and credit them for benefit purposes	40	14
Raise payroll tax rates by 2 percentage points effective in 2005 (employer + employee)	104	34

Source: U.S. Social Security Administration (SSA), Office of Chief Actuary, "Estimates of Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security," Memorandum, January 31, 2002; SSA, Office of Chief Actuary, "Preliminary Estimates for a Proposal to Reduce Benefits above the Level Provided at the 30th Percentile under Present Law," Memorandum to Bob Pozen from Steve Goss, August 21, 2003; and SSA, Office of Chief Actuary, "Estimated OASDI Long-Range Financial Effects of Several Provisions Requested by the Social Security Advisory Board," Memorandum to Stephen C. Goss, Chief Actuary, from Chris Chaplain, Actuary, Alice H. Wade, Deputy Chief Actuary, February 7, 2005.

wage increases. This amounts to eliminating the real increase in future Social Security benefits (since they would only keep up with prices, not wages) and would cause the replacement rate to decline continuously over time. By 2050, benefits for new retirees would be 39 percent lower than projected under current law, and the average replacement rate would be approximately 25 percent rather than the 43 percent that prevails today.

This shift in the way initial benefits are determined would have a very large effect on Social Security's solvency: The chief actuary of Social Security has estimated that this change alone would more than eliminate the seventy-five-year deficit and result in the system running a surplus beyond the seventy-five-year horizon.¹¹

Proponents of price indexing initial benefits argue that it offers a way to restore Social Security's solvency without reducing benefits below the

inflation-adjusted level enjoyed by today's retirees. Opponents argue that the replacement rate is a natural way to gauge the adequacy of the safety net provided by Social Security, and the index switch amounts to a gradual but ultimately dramatic diminution of one of the primary social insurance functions of the system.

2. **HYBRID INDEXING.** Pozen, Schieber, and Shoven have suggested a change in the indexation of initial benefits that preserves the most important safety net features of Social Security.¹² They propose wage indexing the benefits for those with low lifetime earnings and price indexing the benefits for high income participants. Under this approach, those least able to absorb cuts (the bottom 30 percent of the lifetime earnings distribution) are exempt from the benefit reductions.¹³

Gradually, the whole benefit structure would become significantly more progressive, as the replacement rates for higher-income participants were reduced but those for lower-income participants were maintained. Under the Social Security Administration's intermediate cost projections, those with an earnings history in the 30th percentile would receive benefits equal to those with the highest earnings history by around 2090. Eventually, the whole benefit structure would become flat, in that everyone with a full-length career would get the same real monthly benefits.

Hybrid indexing (also known as progressive price indexing) would not reduce overall costs as much as straight price indexing, but it still has a significant effect on Social Security's solvency. In 2003, the chief actuary of Social Security estimated that this hybrid indexing scheme would eliminate approximately 71 percent of Social Security's seventy-five-year deficit. Similarly, it would reduce the shortfall at the end of the seventy-five-year window by 70 percent. Rather than ever-widening deficits in the seventy-sixth year and beyond, hybrid indexing would produce smaller and smaller deficits, and eventually, a surplus.

3. **INCREASING THE FULL BENEFIT AGE.** The full benefit age (FBA) is the age at which a single individual gets the full monthly benefit determined by the formula linking benefits to prior earnings. Those who retire after sixty-two but before the FBA get less than full benefits, and those who retire later (up to seventy) get more. The FBA is sixty-five for those born before 1983. For those born in 1940, who turned sixty-five in 2005, the FBA is sixty-five years and six months. It is scheduled to increase in

an uneven manner until it reaches sixty-seven for those born in 1960. Under current law, it will then remain at sixty-seven indefinitely. Although benefits are adjusted when people retire earlier or later than the FBA, raising the FBA, or normal retirement age, is equivalent to a cut in monthly benefits, regardless of when someone commences benefits.

The rationale for increasing the FBA is that life expectancy has increased very substantially and will likely continue to do so, and that life expectancy raises costs because benefits are received over a longer period, on average. As a rough approximation, each year's new cohort of sixty-five-year-olds can expect to live about three weeks longer than the previous year's cohort. The question is whether all of that extra life should translate into higher lifetime benefits under Social Security. More to the point, longer life expectancies are an important cause of Social Security's financial problems. Increasing the FBA could reduce, eliminate, or in some cases more than compensate for these costs.

There are a variety of ways to increase the FBA. One possibility would be to accelerate the scheduled increase to sixty-seven so that it applies to those born in 1949 (fifty-six-year-olds in 2005) rather than those born in 1960 (forty-five-year olds in 2005). After that, the FBA would increase very gradually for younger workers until it reaches seventy for those born in 2021. This plan would eliminate about 36 percent of the seventy-five-year deficit and about 29 percent of the cash-flow shortfall in the seventy-fifth year.¹⁴

An alternative way of indexing the system to life expectancy would be to calculate each year the expected cost of improvements in longevity. The monthly benefit formula could then be adjusted to keep lifetime benefits roughly constant as life expectancy increased, thereby insulating the system from changes in life expectancy. This approach would eliminate about one-quarter of the seventy-five-year deficit.¹⁵

4. INCREASING THE NUMBER OF YEARS USED TO CALCULATE BENEFITS. Social Security currently counts workers' highest thirty-five years of indexed earnings in determining their retirement benefits. There have been proposals to increase the number of years used in the calculation. For instance, Social Security could use the best forty years of indexed earnings in the computation. Clearly, this would be a benefit cut, in that every worker's average indexed earnings will be lower if they are based on

the best thirty-five years plus five years that were not good enough to enter into the old calculation. The benefit reductions would be concentrated on those whose covered careers were thirty-five years or shorter, since the additional years would be entered as zeros. Social Security estimates that moving to a forty-year calculation would lower the promised benefits enough to eliminate 22 percent of the seventy-five-year deficit and 11 percent of the revenue shortfall at the end of the seventy-five-year window, in 2078.

5. CHANGING THE BENEFIT FORMULA. Another way to reduce benefits is a straightforward revision in the benefit formula. The formula determines the benefits of a single worker at the FBA as a function of his or her average indexed monthly earnings (AIME). Because the formula is progressive, replacing a higher fraction of low-wage than of high-wage earnings, there are two “bend” points: in 2005, one at \$627 per month and the other at \$3,779 per month.¹⁶ Up to the first bend point, the monthly benefit amount is 90 percent of the AIME. Between the two bend points, an extra \$1 of AIME results in an extra 32 cents of monthly benefits, and beyond the second bend point an extra \$1 of AIME produces an extra 15 cents in benefits. If, for example, the 90 percent rate were left unchanged, but the 32 and 15 percent rates in the formula were gradually reduced to 21 and 10 percent, respectively, by 2035, the impact on solvency would be considerable. Social Security estimates that this particular revision to the benefit formula would eliminate 85 percent of the seventy-five-year deficit and 57 percent of the deficit in 2078, at the end of the seventy-five-year window.

Increasing Revenues

As noted above, some people believe that higher Social Security taxes would result in more government spending (or substitute for other taxes), rather than increasing saving. Others believe that failure to raise revenue will put excessive pressure on future benefits. But both sides agree that from a fiscal perspective, raising the revenues of the system would help its solvency.

I. INCREASING THE EARNINGS CAP SUBJECT TO SOCIAL SECURITY PAYROLL TAXES. Currently, the payroll tax is imposed on taxable earnings

up to \$90,000. This cap excludes about 15 percent of total earnings in the economy. Even though the cap is indexed for wage inflation, the proportion of earnings above the cap has increased, due to the widening dispersion of earnings. If the cutoff were increased so that 90 percent instead of 85 percent of total earnings were subject to tax, the cutoff amount would have to be increased to approximately \$150,000. Although the extra taxable earnings would increase future benefits, the change would improve the solvency of the system, since all of the extra earnings would be in the third tier of the benefit formula. Social Security estimates that this policy would solve almost 40 percent of the seventy-five-year deficit, but only 14 percent of the 2078 cash-flow deficit.

2. RAISING THE PAYROLL TAX RATE. Another straightforward way to improve the solvency of Social Security is to raise the Social Security payroll tax rate. Raising the combined employer and employee payroll tax to 14.4 percent (from 12.4 percent) would eliminate the entire seventy-five-year deficit. But it would only reduce the cash-flow deficit in 2078 by about one-third.

What We Would Do

As we have noted, we agree on many issues and disagree on others. Given our menu of options, here are our recommendations for Social Security reform:

Orszag would achieve sustainable solvency with a combination of benefit reductions and tax increases. Low-income participants and other vulnerable beneficiaries would be protected from most or all of the benefit cuts. Some of the benefit cuts and tax increases would be indexed to improvements in life expectancy. A complete and detailed plan along these lines is presented in his book with Peter Diamond, *Saving Social Security: A Balanced Approach*.¹⁷

Shoven, taking into account political feasibility as well as economic attractiveness, would institute hybrid indexing and also index the full benefit age to changes in life expectancy that occur after 2022. Individual accounts could be considered separately, once long-run solvency is restored with these two measures. *Shoven* would also support more radical reform involving sizable and mandatory individual accounts along

with flat traditional Social Security benefits that are more progressive than at present, providing the same basic benefits to all workers. Such a plan is laid out in his book with Sylvester Scheiber, *The Real Deal: The History and Future of Social Security*.¹⁸

Conclusion

We have tried to emphasize two things over everything else. First, restoring solvency to Social Security requires either increasing contributions to the system or reducing the promised benefits, or some of each. Nothing else will work. Second, taking the necessary steps sooner rather than later has dramatic advantages. We even agree on most of the other goals of Social Security reform. Restoring Social Security's solvency is manageable, particularly if it is done promptly. There are several ways to accomplish the task and make Social Security secure for generations to come. We want to preserve and enhance the progressivity of the system and protect the most vulnerable. Similarly, we both feel that the United States should increase its national saving rate, and that Social Security should be reformed in a way consistent with that goal. We also agree that whatever form Social Security reform takes, many households need to increase their retirement saving over and above what the program provides; recent empirical studies have pointed the way toward accomplishing that goal.¹⁹

Notes

1. Authors' calculation using Urban-Brookings Tax Policy Microsimulation Model (version 0304-3).

2. Solvency data can be found in U.S. Social Security Administration, "The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds" (Washington: letter of transmittal dated March 23, 2004).

3. Wall Street Journal/NBC News poll, February 10–14, 2005; reported in Jackie Calmes and John Harwood, "Greenspan Supports Bush on 'Private Accounts': Endorsement Comes as Poll Shows Rising Public Doubt on Social Security Change," *Wall Street Journal*, February 17, 2005, p. A1.

4. Edward Gramlich has also proposed sensible rules for assessing Social Security reform. See Gramlich, "Rules for Assessing Social Security Reform," remarks

at the annual conference of the Retirement Research Consortium, National Press Club, Washington, August 12, 2004.

5. Authors' calculations using benefit data provided by the Social Security Administration.

6. For example, if benefits were reduced this year but only for those aged fifty-four or younger, the required benefit reduction would be about 25 percent. If reform were delayed until 2042 and benefits were reduced only at that time for those fifty-four or younger, the benefit reduction required to achieve seventy-five-year balance would be somewhere between 70 and 90 percent (authors' calculations). In other words, delaying reform means that it becomes increasingly untenable to protect those who are retired or near retirement.

7. Merely eliminating the deficit over the next seventy-five years, while preserving the current structure of Social Security, would result in the appearance of another seventy-five-year deficit as the projection window rolls forward in time. This phenomenon is referred to as the terminal-year problem. For example, the seventy-five-year window for the 2005 projections extends from 2005 through 2079. For the 2006 projection, the actual outcome in 2005 will be included in the initial trust fund balance, and the seventy-five-year window for the projection will shift to 2006 through 2080. Since retirees in the future are expected to live longer, and the system is still transitioning to the effects of lower fertility and immigration rates (resulting in slower growth of the labor force), the program is projected to have a negative net cash flow in 2080. Thus the effect of adding 2080 is to increase the seventy-five-year actuarial imbalance. In our view, reform should ensure that the mere passage of time does not necessarily reintroduce a seventy-five-year deficit.

8. See, for example, Kent Smetters, "Is the Social Security Trust Fund a Source of Value?" *American Economic Review* 94, no. 2, *Papers and Proceedings* (May 2004): 176–81; and Sita Nataraj and John B. Shoven, "Has the Unified Budget Undermined the Federal Government Trust Funds?" paper presented at the annual conference of the Retirement Research Consortium, National Press Club, Washington, August 12–13, 2004.

9. Peter Diamond and Peter Orszag, *Saving Social Security: A Balanced Approach* (Brookings, 2004).

10. After one starts receiving Social Security retirement checks, the monthly benefits are increased annually to keep pace with price inflation (the Consumer Price Index).

11. The Office of the Chief Actuary finds that excluding the individual accounts, Model 2 would roughly eliminate the seventy-five-year imbalance and also result in the program running a surplus at the end of the seventy-five-year window. The index switch alone has bigger effects, because Model 2 involves higher benefits for widows and the lifetime poor that partially offset the indexing effects.

12. Robert Pozen, Sylvester J. Schieber, and John B. Shoven, "Improving Social Security's Progressivity and Solvency with Hybrid Indexing," *American Economic Review* 94, no. 2, *Papers and Proceedings* (May 2004): 187–91.

13. Under their proposal, Social Security would calculate the 30th percentile of the average indexed monthly earnings distribution in 2012. That amount is

projected to be slightly over \$2,000 per month. The figure would be indexed after 2012 by the average wage rate in the economy. Anyone whose average indexed lifetime earnings are below this figure (that is, in the bottom 30 percent of retirees in terms of lifetime earnings) would continue to enjoy wage indexed benefits; that is, they would have precisely the same future benefits as currently promised in the law. At the same time, those at the top of the distribution (those whose average indexed earnings are at or above the payroll tax cutoff (\$7,500 a month or \$90,000 per year in 2005) would have their initial retirement benefits linked to the consumer price index). Those between the 30th percentile and the earnings cap would have their benefits go up faster than prices but slower than wages. Those just above the 30th percentile would have their benefits mostly linked to wages, while those just below the cap would be mostly tied to prices.

14. The full benefit age in 2080 would be approximately 69.5 years.

15. U.S. Social Security Administration, Office of Chief Actuary, "Estimate of Financial Effects for a Proposal to Restore Solvency to the Social Security Program," Memorandum to Peter Diamond, Professor, MIT, Peter Orszag, Senior Fellow, Brookings Institution, from Stephen C. Goss, Chief Actuary, October 8, 2003, p. 2.

16. The bend points increase each year, according to the average wage rate in the economy.

17. Diamond and Orszag, *Saving Social Security*.

18. Sylvester J. Schieber and John B. Shoven, *The Real Deal: The History and Future of Social Security* (Yale University Press, 1999).

19. William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Saving," *Tax Notes*, March 7, 2005, pp. 1207–14. See also the Retirement Security Project (www.retirementsecurityproject.org).