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A Special Issue on Social Security

Saving Social Security: The Diamond-Orszag Plan

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Summary

Social Security is one of America's most successful government programs. It has helped millions of Americans avoid poverty in old age. To be sure, the program faces a long-term deficit and is in need of updating. But Social Security's long-term financial health can be restored: the projected deficit is small enough that it can be eliminated through a progressive reform that combines modest benefit reductions and revenue increases.

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Introduction

Social Security is one of America's most successful government programs. It has helped millions of Americans avoid poverty in old age, upon becoming disabled, or after the death of a family wage earner. To be sure, the program faces a long-term deficit and is in need of updating. But Social Security's long-term financial health can be restored through modest adjustments. Major surgery is neither warranted nor desirable, in our view.

Over the next 75 years, the actuarial deficit in Social Security amounts to 0.7 percent of Gross Domestic Product (GDP); projected out forever, the deficit is 1.2 percent of GDP. (Most of the time you will see Social Security benefits measured as percentages of "taxable payroll"—the base of Social Security taxes. "Taxable payroll" is roughly 40 percent of GDP, so deficit numbers as a percentage of taxable payroll are roughly 2 1/2 times deficits as percentages of GDP.) The important thing is that this projected deficit is small enough that it can be eliminated through a progressive reform that combines modest benefit reductions and revenue increases. In this article we will explain briefly how that can be done; more detail can be found in our book, *Saving Social Security* (Brookings 2004).

Since Painful Choices Must Be Made, a Key Question Is, Which Ones?

The Social Security deficit can be eliminated only through different combinations of politically painful choices: tax increases and benefit reductions. Unfortunately, too many analysts and politicians have ignored this reality, responding to the painful alternatives by embracing "free lunch" approaches.

Some unrealistically assume trillions of dollars will be transferred from the rest of the budget to Social Security, despite substantial deficits projected in that part of the budget. Others would let Social Security borrow trillions to finance investment in stocks, playing off the difference in expected returns between stocks and Treasury bonds—but without taking risk into account.

Yet avoiding real reform, either through delay or a free lunch approach, merely exacerbates the painful choices that will ultimately be necessary. Even those who disagree with the specifics of our plan should agree that it is gimmick-free; unfortunately, too few other plans meet this relatively low standard.

Our plan makes the painful choices that are necessary—selecting a combination of benefit and revenue changes to restore long-term balance. In doing so, it focuses on three areas which contribute to the actuarial imbalance: improvements in life expectancy, increases in earnings inequality, and the burden of the legacy debt from Social Security's early history.

Addressing Improvements in Life Expectancy

The first area is increasing life expectancy. Since 1940, life expectancy at age 65 has increased by four years for men and five for women, and is expected to continue rising. And of course, further years of life means further years of Social Security payments.

To offset the cost from further increases in life expectancy, we propose a balanced combination of benefit reductions and tax increases. Specifically, in each year the Office of the Chief Actuary would calculate the net cost to Social Security from the improvement in life expectancy. Half of this cost would be offset by a reduction in benefits, which would apply to all workers age 59 and younger. The other half would be financed by an increase in the payroll tax rate.

Implementing this proposal would reduce the seventy-five-year actuarial deficit by 0.55 percent of taxable payroll, slightly less than a third of the currently projected deficit.

Addressing Increasing Earnings Inequality

Social Security's financing is affected by two recent trends: the increase in the share of earnings that are above the maximum taxable earnings base ($90,000 in 2005) and are therefore untaxed, and the widening of the difference in life expectancy between lower earners and higher earners.

Over the past two decades, the fraction of aggregate earnings above the taxable maximum has risen from 10 to 15 percent. Our plan gradually raises the taxable maximum, so that the percentage of aggregate earnings above it returns about halfway to its 1983 level—that is, to 13 percent—by 2063. (This raises the payroll tax for roughly six percent of workers each year, those with the highest earnings, and raises the marginal tax rate for even fewer workers.)

Furthermore, people with higher earnings and more education are increasingly tending to live longer than less-educated, lower-earning workers. This hurts Social Security finances and reduces progressiveness on a lifetime basis, since the highest earners receive payments over an increasingly longer period compared to everyone else. To offset this trend, our plan would gradually reduce the highest tier of the benefit formula, affecting the 15 percent of workers with the highest lifetime earnings.

These two changes would reduce the seventy-five-year actuarial deficit by 0.43 percent of taxable payroll.

Confronting the Burden of the Legacy Debt

Third, and finally, our plan addresses the burden of the legacy debt. Benefits paid to almost all current and past cohorts of beneficiaries exceeded what could have been financed with the revenue they contributed. This difference is what we call the legacy debt. Without this debt—that is, if earlier cohorts had received only the benefits that could be financed by their contributions plus interest, the trust fund’s assets today would be much greater. Those assets would earn interest, which could be used to finance benefits.

We cannot take back the benefits that were given to Social Security’s early beneficiaries, and most Americans seem unwilling to reduce benefits for those now receiving them, or soon to receive them. Those two facts largely determine the size of the legacy debt.

The key issue is how to finance this legacy debt across different generations, and across different people within generations. We propose three changes that contribute to restoring balance and represent an allocation of the financing of the program’s legacy debt:

First, mandate Social Security coverage for newly hired state and local government workers, so that eventually all workers will bear their fair share of the cost of the nation’s earlier generosity.

Second, create a legacy tax on earnings above the maximum taxable earnings base, so that very high earners contribute to financing the legacy debt in proportion to their full earnings. This legacy tax would start at 3.0 percent and increase along with the universal charge, described next.

Third, create a universal legacy charge. Roughly half will appear as a benefit reduction for all beneficiaries becoming eligible in or after 2023. The rest will appear as an increase in the payroll tax from 2023 onward. These charges, together, will gradually increase, in order to help stabilize the ratio of the legacy debt to taxable payroll.

These three approaches to the legacy debt issue would reduce the seventy-five-year actuarial deficit by 0.19, 0.55, and 0.97 percent of taxable payroll respectively.

Our three-part proposal would restore seventy-five-year actuarial balance and ensure that the trust fund is slightly rising relative to expenditures at the end of 75 years. It also provides sufficient resources to finance targeted improvements for widows, workers with low earnings over a long career, workers disabled at young ages, and young surviving children.

The Effect of Our Plan on Workers' Benefits and Payroll Taxes

What do these various changes imply for the benefits that workers will receive, and for the taxes they will pay?

Workers who are 55 or older will experience no change in their benefits from those scheduled under current law. For younger workers with average earnings, our proposal involves a gradual reduction in benefits from those scheduled under current law. For example, the reduction in benefits for a 45-year-old average earner is less than 1 percent; for a 35-year-old, less than 5 percent; and for a 25-year-old, less than 9 percent. Reductions are smaller for lower earners, and larger for higher ones.

Our plan combines its gradual benefit reductions with a gradual increase in the payroll tax rate. The combined employer-employee payroll tax rate would rise from 12.4 percent today to 12.5 percent in 2015, 13.2 percent in 2035, 14.2 percent in 2055 and 15.4 percent in 2078; it would continue to rise slowly over time thereafter. This gradual increase in the payroll tax rate slows the decline in replacement rates for any given retirement age.

Our Plan Properly Does Not Include Individual Accounts, Which Are Problematic as a Substitute for Traditional Benefits

Our plan shows that Social Security can be saved without dramatically changing its form. Many recent reform plans have instead replaced part of Social Security with individual accounts. That would be a grave mistake.

Individual accounts, such as 401(k)s and Keoghs, already provide an extremely useful supplement to Social Security, and can be improved and expanded (as will be discussed in a future column). In our view, however, individual accounts are not a desirable substitute for traditional Social Security which provides the core layer of financial security during a particular time of need.

This is especially true given the trend in private pensions of moving from defined benefit plans to 401(k)s; that trend increases the correlation between the risks already being borne by workers and the risks that would be borne if individual accounts were to be created.

Moreover, even apart from considerations of risk, individual accounts would create a massive cash-flow problem for Social Security. To understand this, consider a system in which individual accounts are combined with a reduction in traditional benefits in such a way that the expected present value of traditional Social Security finances over the accountholder's lifetime is unaffected, as is roughly the case with the President's proposal.

Here is how such a system might work: A worker with an individual account would be considered to owe a "debt" to the Social Security trust fund equal to the amounts diverted from the trust fund to the individual account, plus the interest the trust fund would have earned on the diverted funds, had they not been diverted to the individual account. Upon retirement, the worker will receive reduced traditional Social Security benefits sufficient to repay his "debt" to the Social Security Trust Fund. Thus, the diversion of payroll tax revenue is effectively a loan. (This approach, developed by the Government Accountability Office, was embraced by President Bush's Commission and by the Bush Administration itself more recently.)

This system holds the Social Security trust fund harmless in expectation from the diversion of revenue over the lifetime of the average worker. But the timing of the cash flows out of, and into, Social Security are very different: Each

generation's outflow of revenue into the individual accounts precedes by many years that generation's offsetting reductions in traditional benefits.

Even with benefit reductions covering interest payments on diverted payroll taxes, the aggregate cash flow is negative for more than forty years, as the diverted revenue exceeds the benefit offsets. And the Trust Fund is permanently lower, since there are always "loans" outstanding.

How can this cash-flow financing problem be addressed? There is a marked reluctance to either reduce benefits or raise taxes. Thus, many recent individual account proposals have simply wished the problem away by assuming that the rest of the federal budget will transfer sufficient general revenue to Social Security to fill the gap.

This approach seems fiscally reckless; the scale of the assumed transfers in many recent proposals are truly astonishing. One recent plan, for example, assumes $7 trillion in transfers over the next 75 years. The underlying actuarial deficit in the program over that period is only $4 trillion. Even with plans with less reliance on general revenues, there is a substantial political risk to traditional benefits from reliance on future congressional willingness to fund Social Security deficits at a time when overall deficits may be very large and the national debt large and growing. Current budget projections make this risk real.

Besides Creating a Cashflow Problem, Individual Accounts Have Other Downsides

Even apart from these substantial financing challenges, replacing part of Social Security with individual accounts would be undesirable for several reasons.

For one thing, Social Security benefits protect against the risks of outliving one's assets or seeing them eroded by inflation during retirement; individual accounts do not. A system of individual accounts could mandate that accountholders purchase inflation-indexed lifetime annuities to provide similar protections, but that would be politically difficult to sustain over time. Similarly, protections for lower-earning spouses may be reduced. Indeed, the President's proposal does not include full annuitization of individual accounts.

Another major issue is whether workers would have pre-retirement access to account balances. Given the way that the accounts have been sold—workers "own" the account—the political pressure to allow such withdrawals before

retirement is likely to be substantial, possibly resulting in rules similar to those for 401(k)s. Granting such access would undercut another of the basic principles of Social Security—to preserve retirement funds until retirement.

The quality of investment decisions and the administrative costs associated with accounts that are part of Social Security are also concerns. Many existing investors are insufficiently diversified and trade excessively. Without strict rules, which may not be sustained, adding more inexperienced investors would compound this problem, and attempts to educate such workers would add greatly to administrative costs.

The bottom line is that individual accounts that are above and beyond Social Security can be substantially improved. But such accounts are simply inappropriate *within Social Security itself.*

Social Security plays a critical role in the lives of millions of Americans and in the federal budget, and reform will inevitably involve perceived pain for some voters. Reform should be particularly sensitive to the needs of the one-third of elderly beneficiaries who receive at least 90 percent of their income from Social Security. Our plan demonstrates that Social Security can be mended in a safe, realistic way, while protecting the most vulnerable beneficiaries. Other plans, in contrast, often simply assume the availability of funds from the rest of the budget that are not likely to be there, leaving future benefits at grave risk.

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