1 *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. As President Bush has emphasized, "Social Security is one of the greatest achievements of the American government, and one of the deepest commitments to the American people."[1] Despite its successes, however, the program faces two principal problems.

First, Social Security faces a long-term deficit, even though it is currently running short-term cash surpluses. Addressing the long-term deficit would put both the program itself and the nation's budget on a sounder footing.

Second, two decades have passed since the last significant changes in Social Security. Since then, as our economy and society have continued to evolve, some aspects of the program have become increasingly out of date. The history of Social Security is one of steady adaptation to evolving issues, and it is time to adapt the program once again.

Restoring long-term balance to Social Security is necessary, but it is not necessary to destroy the program in order

to save it. To be sure, some analysts reject the view that Social Security's projected financial problems are serious enough to warrant any changes right now.[2] Others, in contrast, exaggerate the difficulty of saving Social Security to justify proposals that would shred the most valuable features of this exemplary program.[3] Our view is that Social Security's projected financial difficulties are real and that addressing those difficulties sooner rather than later would make sensible reforms easier and more likely. The prospects are not so dire, however, as to require undercutting the basic structure of the system. In other words, our purpose is to save Social Security both from its financial problems and from some of its "reformers."

In this book we present a plan for saving Social Security.[4] Our approach recognizes and preserves the value of Social Security in providing a basic level of benefits for workers and their families that cannot be decimated by stock market crashes or inflation, and that lasts for the life of the beneficiary. Our plan updates Social Security to reflect changes in the labor market and life expectancies. And it eliminates the long-term deficit without resorting to accounting gimmicks, thereby putting the program and the federal budget on a sounder financial footing.

Our plan to restore long-term solvency has three components, each of which addresses one of the factors that contribute to the long-term deficit in Social Security: improvements in life expectancy, increased earnings inequality, and the ongoing legacy debt that arises from the program's generosity to its early beneficiaries. Each component of our reform plan includes adjustments to both benefits and revenue to help close the long-term deficit.

The first of these components is the life expectancy component. Life expectancy at age 65 has risen by four years for men and five years for women since 1940, and it is expected to continue rising in the future. Increases in life expectancy make Social Security benefits more valuable to recipients, because the benefits are paid over more years. But for that very reason, increases in life expectancy also raise the cost of Social Security.

Many observers have recognized that it makes sense to adjust Social Security for the effects of increased life expectancy. Previous proposals to do this, however, have adopted the extreme view that all of the adjustment should occur through reductions in benefits.[5] Instead, we propose a balanced approach in which roughly half the life expectancy adjustment

occurs through changes to benefits and the rest through changes to payroll taxes.

The second component of our plan addresses earnings inequality, which has risen substantially in the past two decades. Inequality of earnings across workers in the labor force affects Social Security in several ways. For example, the payroll tax is levied on earnings only up to a certain level (in 2003 that level, the maximum taxable earnings base, was $87,000). In each year over the past two decades, about 6 percent of workers have had high enough earnings that some of their earnings were above the maximum taxable earnings base and therefore not subject to the payroll tax. These higher-income workers have enjoyed disproportionately rapid earnings growth over that period, so that the share of economy-wide earnings not taxed for Social Security has risen substantially. In 1983, when the last major reform of Social Security was undertaken, 10 percent of all earnings were above the maximum taxable earnings base. By 2002 that share had risen to about 15 percent.

In addition to having more of their earnings escape taxation by Social Security, high-income workers have enjoyed increasing life expectancies relative to other workers. This increasing difference in life expectancy tends to diminish the progressivity of Social Security (that is, its provision of relatively more generous benefits to lower-earning workers) on a lifetime basis. The life expectancy adjustments in the first component of our plan are based on average increases in life expectancy for the entire population. Since life expectancy for higher earners is increasing more rapidly than the average, an additional adjustment just for higher earners is warranted.

To address the effect of earnings inequality on Social Security, our plan again includes a balance of revenue and benefit adjustments. First, we propose gradually raising the maximum taxable earnings base until the share of earnings that is above the base—and hence escapes the payroll tax—has returned to roughly its average level over the past twenty years. This change would gradually reduce the share of earnings not subject to the payroll tax until it reaches 13 percent in 2063, roughly halfway between its current level and its level in 1983. Second, to make Social Security somewhat more progressive, and thereby offset the effects of disproportionately rapid gains in life expectancy among higher earners, we

propose a benefit reduction that affects only relatively high earners. Currently, about 15 percent of workers newly eligible for Social Security benefits have sufficiently high earnings that a portion of those earnings falls in the highest tier of the Social Security benefit formula. Our benefit adjustment for income inequality consists of a gradual, modest reduction in benefits that would affect only those with earnings in this highest tier.

The third component of our plan recognizes the legacy cost stemming from Social Security's history. The first generations of beneficiaries received far more in benefits than they had contributed in payroll taxes. Beneficiaries in the earliest years of the program, for example, contributed for only a few years of their career but then received full benefits over their whole retirement. The decision to provide ample benefits to these early beneficiaries is understandable: most of them had experienced hardship during the Great Depression, many had fought in World War I or World War II, and elderly poverty rates were unacceptably high. But those benefits did not come free: the iron logic of accounting requires that since those early retirees received more in benefits than they had paid in, later generations of retirees must receive less. In other words, the system's generosity to early beneficiaries generated an implicit debt, which we refer to in this book as Social Security's legacy debt. That debt can be defined as the accumulated difference between benefits and taxes (accumulated at the market rate of interest) for past and current beneficiaries. This legacy debt imposes an ongoing cost on participants in the program, which we call the legacy cost. (Box 1-1 further explains the origin of this legacy and how the burden it imposes on current and future beneficiaries can be understood as the cost of servicing an implicit debt.)

We all inherit a legacy from Social Security's history. Even if we wanted to, nothing we can do now could take back what was given to Social Security's early beneficiaries. In addition, most people are unwilling to reduce benefits for those already receiving them or nearing retirement. Those two facts determine the size of Social Security's legacy debt. And once that debt is determined, its cost cannot be avoided: the only issue is how we finance that cost across different generations.

Social Security's legacy is not new. It has been with us since the origins of the program itself. But the idea of a Social Security reform based in part on explicitly recognizing the need to share the cost of that legacy is

new. We propose to reform the financing of the legacy debt through three changes:

—First, we would gradually phase in universal coverage under Social Security, to ensure that all workers bear their fair share of the cost of the nation's generosity to earlier generations. Currently, about 4 million workers, almost all of them in state and local governments, are not covered by Social Security. Their nonparticipation means that those workers escape any contribution to the financing of the legacy debt.

—Second, we would impose a legacy tax on earnings above the maximum taxable earnings base, thereby ensuring that very high earners contribute to financing the legacy debt in proportion to their full earnings. The legacy tax above the base would start at 3.0 percent and gradually rise to 3.5 percent by 2080.

—Third, we would impose a universal legacy charge on future workers and beneficiaries, roughly half of which would be in the form of a benefit reduction for all beneficiaries becoming eligible in or after 2023, and the rest in the form of a very modest increase in the payroll tax from 2023 onward.[6] This universal legacy charge would gradually increase over time, so as to help stabilize the legacy debt as a share of taxable payroll.[7]

This approach to financing the legacy debt reflects a reasonable balance between current and distant generations, between lower earners and higher earners, and between workers who are currently covered by the program and workers who are not. As explained in more detail in later chapters, it is meant to keep the full cost of servicing the legacy debt from simply being pushed further into the future for our children and grandchildren to pay.

As an alternative to some of our proposals for benefit reductions or revenue increases, policymakers could dedicate revenue from another specific source to Social Security. For example, the estate tax could be reformed rather than eliminated entirely, as the Bush administration has proposed, and some or all of that revenue could be dedicated to Social Security. In other words, policymakers who object to certain elements in our plan could substitute for those elements a dedicated stream of revenue from a reformed estate tax.

Our three-part proposal would restore long-term balance to Social Security as that term is conventionally understood: actuarial balance over

Box 1-1. ***Understanding the Legacy Cost in Social Security***

To see how the early history of Social Security gave rise to today's legacy cost, imagine that, many decades ago, your great-grandfather fell very ill. He had no accumulated assets and no health insurance, so he had to rely on his son, your grandfather, to pay his medical bills. Your grandfather agreed to do this, despite the financial burden, not only because he loved your great-grandfather and was grateful for his upbringing, but also because he was confident that his own son, your father, would similarly be willing to finance his (that is, your grandfather's) medical costs late in life. Your father fulfilled that expectation, but at the cost of running down his own assets, because he in turn was confident that he could rely on you to finance his health care expenses during retirement.

At this point, you inherit a family legacy in the form of an implicit debt, which originated with your great-grandfather's illness and has since been passed from one generation of your family to the next. If you accept the responsibility to finance your father's health care costs as he did his father's, you assume the debt imposed by that legacy, in the expectation that your own child will pay for your health care costs when you grow old. In this way the legacy of that initial decision to finance the health care costs of your great-grandfather is passed on to yet another generation.

What if you renege on your obligation to your father and refuse to pay his medical bills? In that case the legacy debt is eliminated, but your father is forced to bear the entire deferred cost of your great-grandfather's medical expenses as well as his own. In other words, canceling the legacy debt in this way requires a "transition generation"—in this case, your father—to pay a very heavy toll.

If the legacy debt simply gets passed from one generation to the next, in what sense is there any cost? In other words, if you pay for your father's health care when he is elderly and your child pays for your health care when you are elderly, aren't you just getting paid back when you are old what you paid in when you were young?

In fact, both you and your father and grandfather do bear a legacy cost, even though you are effectively repaid in retirement for the money you spent on your father when young. The reason is that you could have earned a market rate of interest on that money in the meanwhile. The legacy cost consists of the forgone returns you would have earned on those funds. Suppose, for example, that you spend $10,000 for your father's health care, and that you would otherwise have earned $1,000 in interest on that $10,000, for a total of $11,000. Suppose then that, decades later, your child spends $10,000 for your health care, paying you back for what you spent on your father.* It might seem that you have broken even, but in fact you are $1,000 poorer than you would have been otherwise. The $1,000 in interest that you would have earned had you not participated in this family

arrangement is your legacy cost. And every future generation that participates will bear a similar legacy cost, all stemming from your grandfather's initial decision to support your great-grandfather in his time of need.

This story, although simplified, is a close approximation to the history of Social Security—and a good description of the challenge for reform. Past and current beneficiaries received benefits disproportionate to their contributions, generating a legacy debt. Whatever the reasons for, and whatever the good that came of, the decision to provide those generous benefits, we all now face the burden of financing the debt created by that decision. That burden takes the form of our having to forgo the higher return that we could have earned on our payroll tax contributions.

The actual Social Security system resembles this simplified example in that we all would earn higher returns on our payroll tax contributions if those contributions could be invested at a market rate of return. That is not possible in reality, however, because our payroll taxes are mostly used to finance benefits for our parents' and grandparents' generations, and our retirement benefits in turn are financed by payroll contributions from subsequent generations.

We could earn a market rate of return on our payroll tax contributions if we failed to pay the benefits promised to the generations before us, but that would impose severe hardship on them. If we act responsibly and do not renege on the promises made to current beneficiaries, the "rate of return" we receive on our Social Security payroll taxes will be lower than the market rate of return. That difference reflects the legacy of Social Security's history and represents the cost that we must pay because of the program's justified generosity to early beneficiaries. The degree to which the rate of return on our contributions falls below a market rate of return determines how much of the cost of Social Security's legacy debt we bear, and how much we pass along to future generations.

To be sure, the legacy associated with Social Security is more complicated than this simplified story. In our example, a single generation accounts for the entire legacy debt; in reality, that debt accumulated over several generations. And unlike the real Social Security, our story did not assume any long-term projected deficit. That underscores an important point that we discuss further in chapter 4, namely, that the legacy debt and the long-term deficit are related, but are also two different things.

*To simplify the story, we assume that the cost of health care does not increase over time. Making the more realistic assumption that health care costs change over time complicates the story but does not alter the underlying conclusion: if some generations received more than the market rate of interest on their payments, others will have to receive less.

a seventy-five-year horizon. Our plan would not only eliminate the seventy-five-year deficit in Social Security, but indeed would produce a modestly growing ratio of the Social Security trust fund to annual costs at the end of the seventy-five-year period. This is important because it makes it more likely that Social Security will not again face a seventy-five-year deficit for a long time to come.

Table 1-1 shows how each of the components of the plan contributes to restoring balance. Our plan combines revenue increases and benefit reductions—the same approach taken in the last major Social Security reform, that of the early 1980s, when Alan Greenspan chaired a bipartisan commission on Social Security. That commission facilitated a reform that included adjustments to both benefits and taxes.[8] Such a balanced approach was the basis for reaching a consensus between President Ronald Reagan and congressional Republicans on one hand and congressional Democrats led by House Speaker Thomas P. O'Neill on the other.

In addition to our three-part plan to restore long-term balance to Social Security, we propose improvements to Social Security's financial protections for certain particularly vulnerable beneficiaries. We focus on changes in four areas: benefits for workers with low lifetime earnings; benefits for widows and widowers; benefits for disabled workers and young survivors; and further protection for all beneficiaries against unexpected inflation. These changes would significantly improve Social Security's ability to provide cost-effective social insurance while maintaining long-term financial balance.

What do these various changes imply for the benefits that individual workers will receive and for the taxes they will pay? Workers who are 55 years old or older in 2004 will experience no change in their benefits from those scheduled under current law. For younger workers with average earnings, our proposal involves a gradual and modest reduction in benefits from those scheduled under current law for successive cohorts. For example, a 45-year-old average earner would experience less than a 1 percent reduction in benefits under our plan. A 35-year-old average earner would experience less than a 5 percent reduction. And a 25-year-old with average earnings would experience less than a 9 percent reduction in benefits (table 1-2). Higher earners would experience somewhat larger reductions in benefits than the average, and lower earners would

Table 1-1. ***Summary of Effects of Proposed Reforms***

Percent

Proposed reform[a]	*Effect on actuarial balance*	
	As share of taxable payroll	*As share of actuarial deficit*[b]
Adjustments for increasing life expectancy		
Adjust benefits	0.26	13
Adjust revenue	0.29	15
Subtotal	0.55	29
Adjustments for increased earnings inequality		
Increase taxable earnings base	0.25	13
Reduce benefits for higher earners	0.18	9
Subtotal	0.43	22
Adjustments for fairer sharing of legacy cost		
Make Social Security coverage universal	0.19	10
Impose legacy tax on earnings over taxable maximum	0.55	29
Impose legacy charge on benefits and revenue	0.97	51
Subtotal	1.71	89
Reforms to strengthen social insurance functions[c]		
Enhanced benefits for lifetime low earners	–0.14	–7
Increased benefits for widows and widowers	–0.08	–4
Hold-harmless provisions for disabled workers and young survivors	–0.21	–11
Completion of inflation protection of benefits[d]	0.0	0
Subtotal	–0.43	–22
Interactions of above reforms	–0.26	–14
Total effect	2.00	104
Alternative: reform existing estate tax[e]	0.60	31

Source: Authors' calculations based on memorandum from the Office of the Chief Actuary.

a. See the text for details of specific proposed reforms.

b. The seventy-five-year deficit is currently estimated to be 1.92 percent of taxable payroll over that period. Numbers may not sum to totals because of rounding.

c. On these reforms and their separate impacts on actuarial balance, see chapter 6.

d. Not included in the package of reforms officially scored by the Office of the Chief Actuary, but should have de minimis actuarial effect.

e. This reform could be enacted in place of one of the other proposed reforms that affect primarily higher earners.

Table 1-2. ***Benefit Reductions under Proposed Reform for Average Earners***

Age at end of 2004	*Change in benefits from scheduled benefit baseline (percent)*	*Benefit at full benefit age (2003 dollars)*[a]
55	0.0	15,408
45	–0.6	17,100
35	–4.5	18,200
25	–8.6	19,400

Source: Authors' calculations.

a. For a retired worker with scaled medium preretirement earnings pattern. This scaled earnings pattern allows wages to vary with the age of the worker but ensures that lifetime earnings are approximately equal to those of a worker with the average wage in every year of his or her career.

experience smaller reductions. These modest reductions in benefits are also in keeping with the tradition set in 1983. For example, the 1983 reform reduced benefits by about 10 percent for those 25 years old at the time of the reform, a slightly larger benefit reduction than under our plan for average earners age 25 in 2004.[9]

It is important to underline that the reductions just described are relative to currently scheduled benefits; they are not absolute reductions from what retirees receive today. (Box 1-2 discusses the use of alternative baselines in evaluating Social Security reform proposals.) Although today's younger workers would experience somewhat larger percentage reductions in scheduled benefits when they retire than older workers, those benefits would still be higher, even after adjusting for inflation, than those of the older workers. An average earner who is 25 years old in 2004, for example, would receive an annual inflation-adjusted benefit at retirement that is more than 25 percent higher than the inflation-adjusted benefit of an average earner who is 55 years old in 2004. The reason is that Social Security benefits increase when career earnings rise, and today's 25-year-olds are expected to have higher career earnings than today's 55-year-olds because of ongoing productivity gains in the economy. Even with the modest benefit reductions in our plan, the result is that inflation-adjusted benefits rise from one generation to the next.

Box 1-2. ***The Baseline for Benefit and Revenue Comparisons***

Discussions of Social Security reform are often confused by the so-called baseline issue. Because the program currently faces a projected imbalance, the issue involves the appropriate basis of comparison for reform plans. One possibility is the "scheduled benefits" baseline, which assumes that all benefits payable under the current benefit formula will be paid, as they would be if full funding were provided. An alternative is the "payable benefits" baseline, which assumes that only those benefits that can be financed by the current payroll tax will be paid. Payable benefits are equal to scheduled benefits for the next few decades, but then they fall increasingly below scheduled benefits. Under the payable benefits baseline, Social Security does not face an imbalance, but that is because that imbalance has effectively been assumed away.

Proponents of some Social Security reform plans use these two baselines selectively to make their proposals seem artificially attractive. To do this, they measure their proposed changes in benefits relative to the payable benefit baseline, which assumes a reduction in benefits but no long-term imbalance. They then measure their proposed changes in the system's financing relative to the scheduled benefits baseline, which contains the projected imbalance. This is not only inconsistent but can leave the impression that benefits are being increased while the deficit is being reduced.

All of the benefit proposals in this book are measured relative to the scheduled benefits baseline. And even though it requires the use of language that could make our proposals appear less attractive, our proposed tax changes are described relative to the current tax structure, which is insufficient to finance scheduled benefits. This combination seems the most straightforward way to describe the changes we propose, to ensure that they are properly understood. In chapter 7, when we evaluate the payroll tax rate under our plan, we compare it both with the current payroll tax rate and with the rate that would be required to finance scheduled benefits.

Our plan balances its modest and gradual benefit reductions with a modest and gradual increase in the payroll tax rate. As table 1-3 shows, the employee share of the payroll tax under our plan would slowly increase from 6.2 percent in 2005 to 7.1 percent in 2055. Because employees and their employers each pay half of the payroll tax, the combined employer-employee payroll tax rate would rise from 12.4 percent today to 12.45 percent in 2015, 13.2 percent in 2035, and 14.2 percent in 2055. This gradual increase in the payroll tax rate helps ensure that

Table 1-3. ***Payroll Tax Rates under Proposed Reform***
Percent of earnings

Year	*Employee rate*	*Combined employer-employee rate*
2005	6.20	12.40
2015	6.22	12.45
2025	6.35	12.69
2035	6.59	13.18
2045	6.84	13.68
2055	7.09	14.18

Source: Authors' calculations based on memorandum from the Office of the Chief Actuary.

Social Security continues to provide an adequate level of benefits that are protected against inflation and financial market fluctuations, and that last as long as the beneficiary lives.

In addition to explaining more fully the motivation for and the details of our plan, later chapters of this book discuss some changes to Social Security proposed by others that are not part of our plan. Some of these, such as diverting revenue from the traditional Social Security program into individual accounts, we regard as ill advised. Others we view favorably but exclude from our plan because they are highly controversial and would complicate the task of restoring actuarial balance and getting the less controversial improvements through Congress. Still others seem to have a worthy purpose but have not been sufficiently researched to justify including them at this point.

In summary, our plan differs from most other recent Social Security reform proposals, and in our view it represents the most auspicious way of reforming the program, for the following reasons:

—It balances benefit and revenue adjustments.

—It restores long-term balance and sustainable solvency to Social Security.

—It does not assume any transfers from general revenue.

—It does not rely on substantial reductions in disability and young survivor benefits to help restore long-term balance.

—It strengthens the program's protections for low earners and widows.

—It does not divert Social Security revenue into individual accounts.

—It preserves Social Security's core social insurance role, providing a base level of income in time of need that is protected against financial market fluctuations and unexpected inflation.

Despite our confidence in the plan's substantive merits, we are under no illusions regarding the political difficulties of enacting it. Social Security reform is controversial, as it should be. After all, Social Security plays a critical role in the lives of millions of Americans and in the federal budget. Reforms to such an important program *should* generate political interest and debate. Nonetheless, we hope that the simplicity and balance of our basic three-pronged plan demonstrate that Social Security can be mended without resorting to the most controversial and problematic elements included in some other recent reform plans.

The plan of the book is as follows. In chapter 2, we review how Social Security works. Chapter 3 considers the criteria that matter when evaluating reform proposals. Chapter 4 discusses the long-term Social Security deficit and its causes. Chapter 5 contains our proposals for restoring actuarial balance, and Chapter 6 our proposals for improving social insurance protections. Chapter 7 draws together the implications of the various pieces of our plan for Social Security revenue and benefits. Chapter 8 explains why we do not include individual accounts in our proposal. Chapter 9 raises and responds to questions that might be asked about our plan and our analysis. Chapter 10 offers a brief concluding discussion.