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Reforming Social Security: A Balanced Plan

PETER A. DIAMOND AND PETER R. ORSZAG

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. Despite these ongoing successes, the program faces a long-term deficit and policymakers should make changes to it sooner rather than later. Addressing the long-term deficit would put the program and the nation's budget on a sounder footing. Restoring long-term balance to Social Security is therefore necessary, but lawmakers do not have to destroy the program in order to save it.

Our plan restores balance to Social Security without drawing on general revenues, preserves the program's basic structure, and strengthens its social insurance functions. Its combination of revenue and benefit changes reflects the type of balanced approach that was successfully adopted in the 1983 reforms of Social Security.

A BALANCED REFORM PLAN

Our plan for restoring actuarial balance has three components, each of which addresses a factor that contributes to the long-term deficit. Each component includes a balanced package of adjustments to both benefits and revenue to help close the long-term deficit:

Life Expectancy. Life expectancy at age sixty-five has risen by four years for men and five years for women since 1940, and is expected to continue rising. Increasing life expectancy raises the value of Social Security benefits to workers, because benefits last as long as the recipient is alive. By the same token, however, improving life expectancy raises Social Security's cost, because beneficiaries then collect benefits over a longer period.

Understanding the Legacy Debt in Social Security

Early generations of Social Security beneficiaries, including most of those receiving benefits today, received larger benefits than could have been financed from their contributions as well as the returns on those contributions at a market rate of interest.

This history imposes a "legacy debt" on future beneficiaries of the program. As a result of the legacy debt, benefits for later generations will be smaller than their payroll contributions accumulated at a market rate of interest. If earlier groups of beneficiaries had received only the benefits that could have been financed by their contributions, plus interest, the Social Security trust fund's assets would be much larger today. Those assets would earn interest, which could be used to finance benefits.

The legacy debt is similar to the U.S. public debt, which reflects the accumulated difference between spending and revenue from America's beginning to the present; because spending has exceeded revenue in the past, we are left with a public debt. The cost of financing that debt requires some future combination of higher taxes and lower spending. So, too, the legacy debt within Social Security reflects the accumulated difference between benefits and revenue for previous and current beneficiaries, and financing that debt requires higher taxes and

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Many observers have recognized that adjusting Social Security automatically for increasing life expectancy makes sense. Previous proposals have taken the extreme approach of doing all of the adjustment through reductions in benefits. Instead, we propose a balanced approach with roughly half the life expectancy adjustment occurring through changes to benefits and the rest through changes to payroll taxes. (Like the other components of our plan, our life expectancy adjustment does not affect benefits for workers who are fifty-five years old or older in 2004. It also does not change the full benefit age—often misleadingly called the "normal retirement age"—for any worker under Social Security.)

Earnings Inequality. Over the past two decades, earnings have risen most rapidly among workers with the highest earnings. This affects Social Security's financing, since the Social Security payroll tax is imposed only up to a maximum taxable level ($87,000 in 2003). Furthermore, life expectancy of people with higher earnings and more education has grown faster than the life expectancy of those with lower earnings and less education. This increasing gap in life expectancy adds to Social Security's financing gap and makes the system less progressive on a lifetime basis (since higher earners collect benefits for an increasingly larger number of years relative to lower earners).

Our plan again includes a balance of

lower benefits than the system could otherwise afford for future generations. The decision to provide benefits to early generations of retirees that were disproportionate to their contributions did not represent unsound policy, but rather a humane response to the suffering imposed on Americans who came of age during World War I, the Great Depression, and World War II. It helped reduce unacceptably high rates of poverty among them in old age and relieved part of the burden on their families and friends as well as on the taxpayers of that era, who would otherwise have contributed more to their support.

Policymakers cannot take back the benefits that were given to Social Security's early beneficiaries, and most Americans would be unwilling to reduce benefits for those now receiving them or for those who are approaching eligibility. Those two facts largely determine the size of the legacy debt. For example, if benefits are protected for anyone age fifty-five or over in 2004, the legacy debt amounts to roughly $11.5 trillion.

Because the size of the legacy debt is, for the most part, already determined, the issue is how to finance it in the future across different generations and across different people within each generation. In financing the legacy debt, Social Security reform should seek a middle ground between paying off the entire debt in one generation and shifting all of it to future generations.

revenue and benefit adjustments. First, the maximum taxable earnings base rises gradually until the share of total earnings that is above the base—and hence escapes the payroll tax—has declined to 13 percent, roughly its average level over the past twenty years. Second, to offset the effects of disproportionately rapid gains in life expectancy among higher earners, benefits are reduced for the highest earners (about 15 percent of workers). Lifetime earnings that fall in the top tier of the benefit formula (above about $44,000 in 2003) add less to benefits than under current law. Instead of the current 15 cents in benefits for each dollar of lifetime earnings in the top tier, our plan gradually reduces the benefit rate to 10 cents of benefits for each dollar of lifetime earnings in the top tier.

Legacy Debt. The third component of our plan recognizes the legacy debt stemming from Social Security's history (see box above).

First, we introduce mandatory Social Security coverage for newly hired state and local government workers to ensure that eventually all workers bear a portion of the cost of the benefits paid out to earlier generations. While most state and local workers are covered by Social Security, about 4 million of them are not. Their nonparticipation means that those workers escape any contribution to financing the legacy debt.

This policy brief is based on findings from *Saving Social Security: A Balanced Approach,* a new book by the authors from the Brookings Institution Press.

"Our plan includes improvements to Social Security's financial protections for some particularly vulnerable beneficiaries—workers with low lifetime earnings, widows and widowers, disabled workers, and young survivors of deceased workers."

Second, we 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 maximum taxable earnings base starts at 3 percent and gradually rises along with the charge for everyone described in the next paragraph, reaching 3.5 percent by 2080.

Third, we impose a universal legacy charge on future workers and beneficiaries, roughly half in the form of benefit reductions for all beneficiaries becoming eligible in or after 2023, and the rest in the form of very modest increases in the payroll tax from 2023 onward. These changes begin right after the last of the benefit reductions that Congress passed in 1983. This universal legacy charge gradually increases over time, so as to help stabilize the ratio of the legacy debt to taxable payroll.

As an alternative to some part of the 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: revenues would be projected to be sufficient for expenditures over the next seventy-five years, and the system would be expected to remain in balance thereafter. In addition, our plan provides some resources for the improvements to benefits detailed below.

SOCIAL SECURITY AS SOCIAL INSURANCE

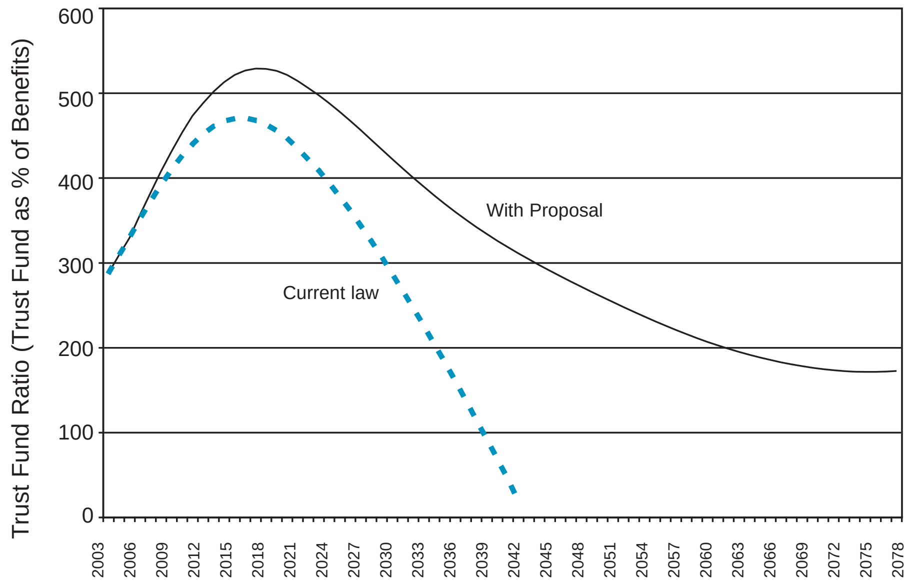
Our plan also includes improvements to Social Security's financial protections for some particularly vulnerable beneficiaries—workers with low lifetime earnings, widows and widowers, disabled workers, and young survivors of deceased workers.

Workers with low lifetime earnings receive meager benefits under Social Security despite the progressive benefit formula. We increase benefits so that minimum-wage workers with at least thirty-five years of work receive a benefit equal to the poverty line in 2012. After 2012, benefits for workers with low lifetime earnings would gradually increase above the poverty line.

Widows typically suffer a 30 percent drop in living standards when their husband dies. We increase the benefits of both widows and widowers, with the aim of leaving a survivor with three-fourths of what the couple had received in benefits when both were alive. For those with low benefits, the increase is financed by the broader program. For higher-benefit couples, the increase in the survivor's benefit is financed by reducing the couple's own combined benefits while both are alive.

Disabled workers as a whole are held harmless by our proposal. While holding total benefits for disabled workers and their families constant over the next seventy-five years, our proposal shifts benefits toward workers who become disabled at younger ages and away from those who become disabled at older ages. Under the current program, workers who become disabled when they are young fall further and further behind the growth of the economy. Our proposal reduces the extent to which this occurs by raising benefits for disabled beneficiaries more rapidly than inflation. Young survivors of deceased workers as a whole are held harmless under our proposal, following the same procedure as for disabled workers.

FIGURE 1
TRUST FUND RATIO



There is currently no protection against unexpectedly high inflation in the years when a worker is between ages sixty and sixty-two. If inflation were to be particularly severe in those two years, workers would experience a significant decline in the inflation-adjusted level of their benefits. For example, a repeat of the inflation rates of 1980 and 1981 (14.3 percent and 11.2 percent) would reduce the real benefits for a particular group by almost 25 percent. To protect against this risk, the plan modifies benefit determination in a cost-neutral fashion.

IMPLICATIONS FOR BENEFITS AND REVENUE

Taken together, these changes are sufficient to restore actuarial balance (see table 1, p. 6). Moreover, the life of the Social Security trust fund is not only extended throughout the projection period, but the trust fund is slowly rising (relative to annual benefits) at the end of the seventy-five-year period, as shown above in figure 1.

What effect will these changes have on individual workers' taxes and benefits? Workers who are fifty-five 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 does lower benefits relative to those scheduled

> *"Our three-part proposal would restore long-term balance to Social Security … over the next seventy-five years, and the system would be expected to remain in balance thereafter."*

TABLE 1:
SUMMARY OF EFFECTS OF PROPOSED REFORMS (PERCENT)

Proposed reform[a]	Effect on actuarial balance: As share of taxable payroll	Effect on actuarial balance: 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	-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.

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

under current law, with the reductions smaller for older cohorts than for younger ones. For example, a forty-five-year-old average earner (in 2004) is projected to experience less than a 1 percent reduction in benefits under our plan. And a twenty-five-year-old with average earnings experiences less than a 9 percent reduction in benefits. Benefits for such workers are still higher, even after adjusting for inflation, than those of the older workers. An average earner who is twenty-five years old

TABLE 2:
BENEFIT REDUCTIONS UNDER PROPOSED REFORM FOR AVERAGE EARNERS

Age at end of 2004	Change in benefits from scheduled benefit baseline (percent)	Inflation-adjusted benefit at full benefit age relative to 55-year-old (percent)[a]
55	0.0	100
45	-0.6	110
35	-4.5	118
25	-8.6	125

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.

in 2004, for example, would still receive an annual inflation-adjusted benefit at retirement that is more than 25 percent higher than the benefit of an average earner who is fifty-five years old. The reason is that Social Security benefits increase when career earnings rise, and today's twenty-five-year-olds are expected to have higher career earnings than today's fifty-five-year-olds because of ongoing productivity gains in the economy (see table 2 above). Higher earners experience somewhat larger reductions in benefits than the average, and lower earners experience smaller reductions.

Like our balanced approach, these modest reductions in benefits are in keeping with the tradition set in 1983. For example, the 1983 reform reduced benefits by about 10 percent for those who were twenty-five years old at the time of the reform, a slightly larger benefit reduction than under our plan for average earners age twenty-five in 2004.

To increase revenue under our plan, the employee share of the payroll tax is projected to gradually 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 is projected to 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, shown in table 3 (see p. 8), helps ensure that 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.

INDIVIDUAL ACCOUNTS

Unlike many other proposals for Social Security reform, our plan does not call for the creation of individual accounts within Social Security. Individual accounts, which include tax-favored private sector accounts such as 401(k)s and IRAs, already provide an extremely useful supplement to Social Security, and they can be improved and expanded. But they

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are simply inappropriate for a social insurance system that provides the basic tier of income during retirement, disability, and other times of need.

TABLE 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

CONCLUSION

Social Security plays a critical role in the lives of millions of Americans and in the federal budget, so reform is naturally controversial.

Our plan represents the most auspicious way of reforming the program because it: balances benefit and revenue adjustments; restores long-term balance and sustainable solvency to Social Security; does not assume any transfers from general revenue; does not rely on substantial reductions in disability and young survivor benefits to help restore long-term balance; strengthens the program's protections for low earners and widows; does not divert Social Security revenue into individual accounts; and preserves Social Security's core social insurance role, providing a base income in time of need that is protected against financial market fluctuations and unexpected inflation.

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