AGING BOOMERS AND DEMOGRAPHIC CHANGE: NEW SOCIAL CONTRACT OR A BLADE RUNNER SOCIETY?

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WHAT IS THE CENTRAL GOAL FOR SOCIAL SECURITY REFORM? ADDING INDIVIDUAL ACCOUNTS OR PRESERVING THE SOCIAL INSURANCE MISSION?


In recent years there has been a contentious political debate in the United States between those on the right and those on the left about Social Security reform. There is general agreement that as of about 2042 it will be necessary to sharply reduce Social Security pensions benefits, or to sharply increase the payroll taxes used to finance the system, or to enact some combination of the two (Board of Trustees, 2004). These would be the choices in the very unlikely event that no substantial reforms were introduced prior to that date. It is generally agreed that the necessary tax increase and benefit cuts will be less draconian if we start to phase in the changes sooner rather than later (Diamond & Orszag, 2004). There is also general agreement that Social Security reform is going to be based on a combination of several reforms, not one reform such as just introducing individual retirement savings accounts. Yet, while there is consensus that many changes will be called for, there is much disagreement about whether the goal should be to radically restructure Social Security or to make more modest reforms designed to preserve its current structure and to retain its traditional focus on social insurance objectives.

Views From the Right

Many on the right would argue that we should take advantage of the projected funding gap as an opportunity to make what they consider long overdue structural changes. Their goal is to transform Social Security into a program designed to meet present and future needs, not past needs. They want a more modest program crafted to be consistent with conservative values and emphasizing such themes as self-reliance, personal freedom, and minimal government (particularly in the social welfare sector). The goal is to restructure the program so that it reduces government spending, rewards individual work effort, and reduces the extent of redistribution that favors low-wage workers, many of whom are, as they see it, receiving pensions that exceed what can be justified on the basis of what they have contributed over the years.

Many reform proposals can be linked to these conservative values and worldview, but the one that has received the most attention is the call to partially privatize Social Security with the introduction of individual accounts. While some on the right have as their eventual goal the full privatization of Social Security (Ferrara, 1985; Ferrara & Tanner, 1998; Peterson, 1999), the most frequently mentioned goal is to restructure Social Security so that it includes both an unfunded social insurance (pay-as-you-go defined benefit) component (pillar) and a funded (defined contribution) individual accounts pillar (President’s Commission to Strengthen Social Security, 2001; Advisory Council on Social Security, 1997).

With partial privatization, over time the amount the government spends on Social Security both as a proportion of the federal budget and as proportion of the Gross Domestic Product would fall. Projections concerning public pensions spending for the United States and the United Kingdom over the next few decades make it clear that the pension burden will be sharply lower in the UK, and there is little doubt that the partial privatization of the British pension system is a major factor (Williamson, 2002). For the UK the favorable projections with respect to the cost of government spending on public pensions in the decades ahead are the good news, and unfavorable projections with respect to trends in the level of these pensions, particularly for low-wage workers, are the closely linked bad news.

Views From the Left

Why are so many on the left opposed to efforts to partially privatize Social Security? They are concerned that efforts to make Social Security more market conforming are going to increase the level of economic inequality. They worry that such a change is likely to
produce both relative and absolute pension benefit reductions for those at the lower end of the income distribution. It is going to put groups such as women (particularly widows), low-wage workers, and minority workers at an increased risk of poverty during their retirement years (Baker & Weisbrot, 1999). They fear that the individual investment accounts are going to subject low-wage workers to an unacceptable level of market risk linked to fluctuations in financial markets (White, 2001). Some are anxious about the likely increase in administrative costs associated with the introduction of individual accounts and the potential impact of these costs on the long-term returns for low-wage workers who will tend to have small-balance accounts (Williamson, 1997). There will also be added costs for the oversight and regulation of those responsible for managing the assets in these individual accounts.

Progressives tend to have very different views than do conservatives about how serious a problem the projected funding shortfall poses and about how to deal with it. They acknowledge that the projected deficit is very real and that steps should be taken relatively soon to deal with it, but they reject the idea that any viable long-run solution to the funding issue must include a mandatory funded individual accounts pillar. They believe that it is possible to bring Social Security into long-run financial balance using a set of reforms that maintain a commitment to the social insurance goals and values held by many of those who framed the program during the 1930s (Baker & Weisbrot, 1999; Kingson and Williamson, 1999). Rather than seeing those original social insurance goals as out of sync with current and future economic realities, they see this aspect of the Social Security system as being at the core of its current and future mission, not just its past mission. They tend to link the popularity of the program over the past six decades to its focus on this social insurance mission. Progressives want to avoid changes in Social Security that will in the long run undermine its social insurance objectives (Baker & Weisbrot, 1999; Diamond & Orszag, 2004).

Social insurance programs are designed to help replace the income lost due to certain identifiable risks across all income groups. They are generally designed so that benefit levels vary across income categories in such a way as to provide benefits that are larger in an absolute sense for those who have paid in the most (high-wage workers), but larger relative to contributions for those with low incomes. In the case of Social Security, such a structure helps assure an income that is adequate to meet the basic needs of low-income workers, many of whom would fall into poverty were it not for the redistributive formula used to compute pension benefits. As with private insurance, the idea is to share the risk (White, 2001). This is more obvious in the case of the disability insurance component of the Social Security program, but it is also at the heart of the old-age and survivors pension program as well. Some workers could remain at work well into their 70s with relative ease, but many others would find this very difficult, if not impossible, for a variety of reasons including age discrimination, health problems, the physical demands of certain types of work, and obsolete job skills.

A Progressive Approach to Reform

Saving Social Security: A Balanced Approach presents one of the most impressive efforts to date to offer a progressive alternative to the hue and cry from the right for the introduction of individual accounts. The authors are two very distinguished Social Security experts: Peter A. Diamond, a professor of economics at MIT, and Peter R. Orszag, a senior fellow in economic studies at the Brookings Institution.

The most important part of the book is Chapter 5 where the authors lay out their three-part plan to shore up Social Security. This book (and this chapter) is important in part because it presents a powerful general approach for restoring actuarial balance to the Social Security program, an approach that will be useful to other analysts quite independent of the specific reform proposals that they incorporate as part of their package of reforms. The chapter is also important because in it they outline a number of specific reform proposals, some of which are quite innovative.

Diamond and Orszag lay out a set of proposals that are designed to deal with three major sources of the projected long-term deficit in Social Security. One source is the increase in life expectancy. The second is the increase in inequality in earnings. The third is what the author’s refer to as the “legacy debt.” The legacy debt is their term for that portion of the projected deficit that can be attributed to the very generous benefits relative to contributions that were made and continue to be made to those who retired during the early decades of the program when many people were contributing and relatively few were eligible for benefits.

Their reforms add up to a combination of benefit cuts and tax increases. This is no surprise as that is typically the case. What is different with these authors compared to many other analysts is that they are so explicit about the fact that the reforms essentially add up to a combination of benefit cuts and tax increases. Central to their approach to reform is the assumption that the best way to reform the system is to do it in such a way that, where possible, there is a balance between cuts in benefits and increases in payroll taxes. That way the burden of paying for the reforms is split relatively evenly between those in the labor force and those who are retired. This is a very powerful idea that other analysts would do well to consider.

To deal with the effect of the increase in life expectancy they call for an annual updating of life tables. Any changes in mortality rates are then used to update projections with respect to the cost of the Social Security program. As life expectancy increases, the projected cost of the program will increase. The next step is to reduce the size of the starting monthly Social Security pension benefit (relative to what it would have been in the absence of the increase in life expectancy) by the amount that will compensate for 50% of the projected increase in cost due to the increase in life
The other 50% of the projected increase in the cost of Social Security is to be paid for by increasing the payroll tax by the amount necessary to exactly balance the savings from the reduction in the starting pension benefit level. Thus each year any increase in the cost of Social Security due to this source would be paid for by the above combination of payroll tax increases and benefit cuts. The size of the payroll tax increase and the size of the cut in the starting benefit would vary from year to year depending on the size of the increase in life expectancy, but because they would both be based on annual changes in life expectancy, the increase in the payroll tax would be gradual as would the reduction in starting benefit levels.

The second set of changes proposed by Diamond and Orszag is designed to deal with the part of the increase in the cost of Social Security that is due to the increasing inequality in earnings among workers. In 1983 approximately 10% of all earnings were untaxed because they were above the income cap for payroll tax purposes also called the taxable maximum. Due to the increase in income inequality since 1983, the share of earnings that falls above the taxable maximum has increased to 15%. Diamond and Orszag propose to increase the taxable maximum by the amount necessary to reduce the share of earnings above that cap from 15% down to 13%. I would argue for rolling it back to the 10% figure for 1983, or at least to do this for the employer’s share of the payroll tax as suggested by Baker and Weisbrod (1999). But Diamond and Orszag opt for the 13% level so as to keep a balance between this reform (which increases revenues) and a second reform designed to fill half of the gap due to the increase in income inequality with a benefit cut. For each source of the increase in the cost of Social Security, their strategy is to cover half of the increase in cost with a revenue enhancer and half with a benefit cut.

The benefit cut made to deal with this second component of the increase in the cost of Social Security is to gradually decrease the size of the pension benefit for high-wage workers. Currently high-wage workers only get a replacement of 15 cents on the dollar of average indexed monthly earnings (AIMEs) above a certain level. They propose that this figure be gradually reduced to 10 cents on the dollar.

The third source of the increase in the cost of Social Security that they discuss is the legacy debt. This turns out to be one of the most innovative aspects of their model. They point out that many current Social Security recipients are getting pensions far in excess of what can be justified based on prior contributions. According to their estimates somewhere between 3 and 4 percentage points of the 12.4% payroll tax is needed to finance this legacy debt.

To increase revenues linked to this source of the projected cost, they would enroll all state and local workers not currently enrolled in the Social Security program. As another revenue enhancer they would add a 3% tax on all earnings above the taxable maximum (the current cap on earnings subject to the payroll tax). Over time it would be necessary to increase this tax somewhat to keep up with the increase in the legacy debt. As with other sources of the increase in the cost of Social Security, part of the projected increase would be covered by a cut in benefits.

In this case the call is (starting in 2023) to reduce the benefit for the newly eligible by .31% per year relative to what it would have been under current legislation (i.e., .31% for 2023, .62% for 2024, etc.). They also call for an increase in the payroll tax rate sufficient to match the revenue saved by reducing pension benefits for the newly eligible. This pair of reforms gets a bit complicated and would be hard for the general public to grasp all the details. But the overall goal is quite simple—to bring future pension benefits and revenues into balance through matched sets of reforms that more or less equally divide the burden due to this source of the projected increase in the cost of Social Security between benefit cuts and payroll tax increases.

Toward the end of Chapter 5 the authors outline a very different alternative for bridging the projected Social Security funding gap. It is not as well developed as the first alternative, but, again, it is very innovative. They point out that current legislation calls for sharp reductions in the estate tax in the years ahead. They then go on to argue that if instead we were to redirect some of these funds to help subsidize the Social Security system, that would offer an alternative way to fill the projected gap. They acknowledge that this would represent a major break from the past with respect to Social Security financing. While this new funding alternative is innovative, and it is a proposal that I would support, it is likely to be very controversial, and I assume that is why they present it as an alternative plan and do not integrate this set of ideas into the general three-part model they propose for saving Social Security.

The early chapters of the book set up the discussion of their three-part plan to shore up Social Security that is presented in Chapter 5. Chapter 6 presents an excellent discussion of the social insurance function of Social Security. They discuss how the reforms that they have proposed do more than restore long-term solvency to the system. They are also designed to improve the social insurance protection for several of the most vulnerable groups, including widows, the disabled, and low-wage workers.

The volume also includes an excellent chapter on individual accounts. The authors offer a detailed explanation as to why they think it is a bad idea to try to incorporate individual accounts as part of Social Security reform. They point out that, for a program designed to provide an assured level of income, it does not make sense to link a substantial fraction of those benefits to what happens in financial markets. Their concern is especially for the two thirds of recipients for whom Social Security makes up the majority of retirement income and even more so for the 20% of recipients for whom Social Security makes up their only source of income. This chapter goes over the variety of ways in which individual accounts could be incorporated as part of the Social Security system, it presents the arguments that have been made on behalf of such accounts, and it reviews the full range of reasons why they think such accounts are a bad idea.
Getting Mass Media Attention

In recent years the mass media have given a great deal of attention to reform proposals advanced by conservatives calling for funded individual accounts. The most innovative ideas for Social Security reform seem to have come from the right, not the left. Progressives have been put in a position of criticizing proposals made from the right, but typically they have not been as successful in coming up with alternatives that attract the same level of attention from the mass media. One reason is that proposals from the left are typically based on a number of modest changes, none of which are viewed as being innovative by the mass media or the general public. Those on the left generally tailor their message for professional audiences and academic outlets; those on the right have shown a much greater penchant for targeting a general audience with a message designed to attract the attention of the mass media. While there may be little, if any, connection between a proposal's ability to attract the attention of the mass media and the quality of the policy embodied in that proposal, there is a need for progressives to come up with Social Security reform proposals that will compete favorably in the arena of the mass media with proposals being advanced by those on the right.

Saving Social Security is very clearly written, it is well documented, it is persuasive, and it is a must read for all journalists who write about Social Security policy as well as the economists and other social scientists who do Social Security policy analysis. It is written for a broad audience, and those without a background in economics will be able to get a lot out of the book even though a background in economics will be useful for a full understanding of some parts of the book. However, to get the kind of mass attention that I believe their proposals deserve, more work is needed to translate the core arguments of this book into a message that will work as an op-ed. I have no doubt that this book will be influential among professional Social Security policy analysts, but there is another crucial audience—the general public. I hope that the authors will make an effort to bring many of these ideas to a truly mass audience through op-eds and the like. This is going to require some simplification of many of their key arguments.

Diamond and Orszag offer a set of reforms that, taken together, will deal with Social Security’s projected funding problem. Equally important, they provide a compelling demonstration that the problem can be solved without the introduction of individual accounts or the partial privatization of Social Security. They outline a number of very useful reforms that I anticipate most serious reform proposals from the progressive left will draw on for many years. Their analysis is useful, in part, because they outline an approach for putting together a balanced set of reforms targeted at specific sources of the projected funding shortfall and, in part, because they present several innovative proposals of interest independent of their three-part framework. Now that their approach has been demonstrated in a convincing way, the door is open to proposals from other progressive analysts who, no doubt, will attempt to achieve the same overall goal with their own set of proposals, albeit a set that is likely to include many of the same proposals that Diamond and Orszag have outlined in this book.

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