



A critical consideration of two books that, between them, cover just about every aspect of Social Security reform currently on the table.

[Touching the

It has now been more than 20 years since the National Commission on Social Security Reform, headed by Alan Greenspan, now chairman of the Federal Reserve, had its recommendations regarding the reform of the Social Security system (this term will be used interchangeably with OASDI) accepted and implemented. Due to continuing demographic, economic, and fiscal challenges, these remedies have not been adequate to the task of placing Social Security in long-term actuarial balance.

The Trustees Report has, for a number of years now, been identifying two dates. The first is the year in which Social Security revenues will be insufficient to pay that year's Social Security benefits, necessitating the liquidation of special Treasury bonds that make up the assets of the OASDI trust fund; the second is the year in which the trust fund balance is reduced to zero. Currently, according to the 2004 Trustees Report, which reports a long-term actuarial deficit of 1.92 percent of payroll, the first year is 2018, the second year is 2042, and at that time, revenues will be sufficient to fund only 73 percent of scheduled benefits

Few issues have been as politically charged over the past 20 years, with the possible exception of health care reform. It has long been a truism that Social Security reform has been the third rail of American politics—a sure and swift path to political oblivion. This, of course, hasn't prevented a number of political leaders and an even greater number of public policy analysts (who are paid to produce recommendations that are rarely implemented) from generating a variety of proposals designed to either “save” Social Security or to re-engineer it.

From the structural point of view, the debate over the past several years has focused on basically two approaches, each of which has a sizeable camp of partisans. The first seeks to find ways to bring financial stability to the system, while keeping the reformed system looking very much like the current system. The second seeks to restructure the system along the lines of a market-driven, defined contribution pension plan.

We are fortunate, then, to have had two books very re-

benefits will need to be cut, or revenues will need to be increased, or some combination of the two will need to occur.

Because they recognize that relying on only one of the two possible levers would be difficult to implement in Congress, they adopt an air of practicality and choose to use both. Additionally, they phase in their proposed changes over a relatively long time frame, in order to minimize any financial or economic dislocations at either the individual or national level.

Before proposing any specific recommendations, Diamond and Orszag spend a lot of time covering how Social Security works and discussing the various sources of the long-term deficit. Their discussion of the workings of Social Security covers much material familiar to those actuaries who had to read any study notes or published materials for their actuarial examinations, while also adding some observations that either illuminate an underappreciated aspect of the system or remind the reader of just who is being affected by all the potential reforms.

For example, they state that OASDI “works to provide recipients with a base level of assured income, one that is protected against inflation, financial market fluctuations, and the risk of outliving one's assets.” At the same time, while they remind us that these benefits were never intended to provide a comfortable retirement by themselves, they point out that for many, including the 20 percent of beneficiaries over the age of 65 for whom Social Security is the only source of income, the benefits aren't even enough to escape poverty.

Additionally, they point out that because so many non-retirement benefits (disability, spouse, ancillary, etc.) are directly tied to the retirement benefit, reductions or modifi-

Third Rail]

By Richard M. Rasiej

cently published that, between them, clearly articulate most, if not all, of the choices we have before us. The first of these, *Saving Social Security: A Balanced Approach* by Peter A. Diamond and Peter R. Orszag, was published in December 2003. The second, *Social Security and Its Discontents*, edited by Michael Tanner, was published in May 2004.

Working Within the System

As can be inferred from its title, *Saving Social Security: A Balanced Approach* promotes reforms that can be supported by members of the first camp. Diamond, an institute professor at the Massachusetts Institute of Technology, and Orszag, a senior fellow at the Brookings Institution, start from the tautology that, in order to achieve long-term actuarial balance in OASDI,

cations will affect beneficiaries who may, as a class, be even more vulnerable than retirees. This concern for enhancing the social adequacy of Social Security as a criterion for evaluating reform proposals is constant throughout the book.

For Diamond and Orszag there are three primary contributors to the long-term deficit. The first is continuing improvements in life expectancy. The second is growing earnings inequality or, put another way, the fact that proportionately more and more wage income has been exempted from OASDI payroll taxes, rising from approximately 10 percent in 1983 to about 15 percent in 2002. Additionally, high-income earners have generally enjoyed greater improvements in life expectancy relative to other workers, further reducing the progressivity of the retirement benefit.

The third contributor is what Diamond and Orszag refer to as the ongoing legacy debt arising from the consequences of providing benefits to the earliest beneficiaries with funds taken primarily from general revenues, rather than earmarked payroll taxes.

They recommend the following changes in revenues and benefits to address each of the three drivers of the long-term actuarial deficit. To address the continuing improvement in life expectancy, they propose a combination of a reduction in the primary insurance amount (PIA)—calculated as a piecewise linear function of average indexed monthly earnings—corresponding to about half of the cost of increased life expectancy, together with an increase in the payroll tax rate to cover the other half of the cost.

To address increased earnings inequality, they propose gradually increasing the maximum taxable earnings base so that no more than 13 percent of earnings are untaxed. Additionally, they would slowly, beginning in 2012, reduce the coefficient of the third bend point in the calculation of the PIA from .15 to .10.

To deal with legacy debt, they would make coverage universal (which by itself would take care of about 10 percent of the long-term deficit), impose a tax on earnings above the wage base approximately equal in size to the current Medicare payroll tax, and eventually (beginning in 2023) impose modest (approximately 1/4–1/3 percent per year) decreases in initial benefits and increases in the payroll tax rate.

Not counting the additional legacy tax on earnings in excess of the wage base, payroll taxes would rise from the current 6.2 percent to about 7.1 percent in 2055. For high-wage earners, Social Security taxes at that time would be 7.1 percent on income up to the wage base and about 1.5 percent of all income in excess of the wage base. Note also that these tax rates apply to workers. Their employers would also be paying taxes at these levels. Over the same time frame, benefits would be cut on the order of 10 percent, although in constant dollars even the reduced benefits will be greater than today's.

The financial impact of these various reforms is approximately 140 percent of the actuarial deficit. Diamond and Orszag also make proposals that are designed to strengthen some of the social insurance functions of the system—for example, enhancing benefits for workers with low lifetime earnings and adjusting benefits for surviving spouses. These enhancements, together with interactions amongst the various reforms, use up most, but not all, of the “excess” 40 percent.

It's possible that Diamond and Orszag do their cause some disservice because of the amount of space they give to the legacy debt, which is a concept that might only serve to confuse the issues. As mentioned earlier, this debt arises from the windfall benefits the earliest recipients of Social Security received relative to any contributions they may have paid into the system. This initial debt compounds over time and is augmented any time that individuals receive benefits whose value is greater than that of their contributions.

There are a number of problems with this concept. First, it's not clear that the concept makes that much sense in an open group context with an infinite time horizon, where there are always new entrants available to pay into the system.

Second, the legacy debt is given a preferred status in terms of the need to pay it down. In other words, if a tax is designed to reduce legacy debt, why not use it for national debt instead?

Third, even though the authors assert that the legacy debt has reduced the return on contributions, there is no convincing demonstration that anyone receiving benefits today would have had higher benefits in the absence of a legacy debt.

Finally, in the absence of a legacy debt, there's no guarantee that Congress would not have made even greater ad hoc increases in benefits or would not have been even more emboldened to raid the trust funds for other initiatives.

Market-Driven Approach

The essays appearing in *Social Security and Its Discontents* are, by and large, papers originally published as a Cato Institute Social Security Paper from 1997 to the present, with the older papers updated to reflect current information. The editor, Michael Tanner, is director of health and welfare studies at the Cato Institute and director of the Cato Project on Social Security Choice.

He has arranged the essays in five broad categories: why Social Security is in its current predicament; how women, the poor, and minorities fare under the existing system; how individual accounts would work; how to deal with issues regarding administrative costs and market downturns; and how to interpret public opinion on individual accounts.

To those who would argue that proponents of individual accounts are insensitive to the social adequacy aspects of the current system, one need look no further than Michael Tanner's essay (one of four he wrote out of the collection of 17) on his “6.2 Percent Solution.”

Under this proposal, workers born on or after Jan. 1, 1950, would have the option of either depositing their portion of the current payroll tax in an individual account and forgoing future accrual of Social Security retirement benefits or remaining in the traditional system, receiving currently projected benefits. The individual account would initially be invested in a balanced fund (60 percent stock/40 percent bond), with choices expanding as account balances grow. Individual account participants would also receive zero-coupon bonds recognizing their earlier contributions to Social Security.

A key provision of this particular individual account proposal is that for those workers whose account balances at retirement are insufficient to purchase an annuity providing income at 120 percent of the poverty level, the government will provide supplementary funds enabling them to make such a purchase. These supplements would be funded from general revenues. It's not clear if those who choose to remain in the current system or workers born before 1950 will receive such a guarantee.

For proponents of individual accounts, the elephant in the room has always been the issue of transition costs. Depending on the type of individual account approach chosen, these costs will range widely, but the low end of the range is still likely to be an enormous number.

For example, as detailed in “The Price of Loyalty” by Ron Suskind, before the tax cuts of 2001, when the 10-year budget surplus was still projected to be \$5.6 trillion, then Secretary of the Treasury Paul O'Neill and Fed Chairman Greenspan (both

of whom supported individual accounts) each independently came up with a transition cost of \$1 trillion to bridge to a system in which everyone under the age of 37 would begin contributing to his or her own individual account and everyone 37 and over would remain in the current system.

Back then, in theory, at least, there was a source for funding the transition. In today's fiscal environment, with an evaporated surplus and significant deficits, room to maneuver is much more constrained.

A number of the authors in the Tanner book try to chip away at transition costs by, for example, redirecting that portion of the tax collected on Social Security benefits that goes to Medicare back to Social Security (which of course would worsen Medicare's woes) and "eliminating corporate welfare," but these suggestions are unlikely to generate the needed resources.

Milton Friedman, in his essay, even goes so far as to assert that transition costs are a mirage; he proposes a thought experiment in which, on a set date, Social Security as we know it is eliminated. All participants, including current retirees, will receive a government bond whose market value is equal to the participant's share of the system's actuarial liability. But there's the rub. In an environment with a ballooning federal debt, the odds that someone trying to realize the value of that government obligation will receive 100 cents on the dollar are not promising.

On balance, the book edited by Tanner appears more explicitly ideological. When the essayists address any of the proposed reforms of the "traditionalists," they tend to do so in a fairly disparaging way. Additionally, they will at times propose arguments in favor of individual accounts, such as the one based on property rights considerations made by Charles E. Rounds Jr., which have at best limited relevance to the current debate.

At the same time, Diamond and Orszag occasionally fall into the trap of using straw-man arguments to express their reluctance

to entertain any reform using individual accounts in any form. For example, they use the increased volatility of returns to which market participants are exposed as a reason for discounting the claims of individual account advocates regarding market returns without addressing the fact that over any sufficiently long period (on the order of 20 to 40 years), market returns would in fact exceed returns on any basket of Treasury bonds.

Neither book really addresses any compromise between two positions that have needlessly become antipodal rather than complementary. What would be wrong with developing a system where a full payroll tax is applied up to some wage level—\$W—in order to fund a traditional Social Security minimum benefit with a meaningful antipoverty provision, with any taxes above \$W directed toward the worker's individual account?

Throughout its turbulent history, the Social Security reform debate has been marked by a reluctance to explicitly engage in a meaningful discussion of the most fundamental question: What is the proper balance between social adequacy and individual equity that a society that wishes to be considered decent and fair should adopt? Although neither book really makes a case for where that point should be located, readers of both books will at least have been thoroughly exposed to virtually all of the relevant issues in the current debate.

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The books:

- ▶ *Saving Social Security: A Balanced Approach*
Peter A. Diamond and Peter R. Orszag
The Brookings Institution, 2004, 278 pp.
- ▶ *Social Security and Its Discontents*
Michael D. Tanner, editor
Cato Institute, 2004, 386 pp.

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