Social Security Reform and Responsibility across the Generations

Framing the Debate

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Recent projections by the Board of Trustees (2006), the group charged with overseeing the Social Security program, suggest that if no changes in policy are made and current trends continue, the Social Security trust funds will be depleted by 2040. Their prediction does not mean 2040 is the exact year in which the depletion would occur, since projections are made each year and it is common for them to fluctuate. Furthermore, it does not mean that in 2040 there would be no money to pay Social Security benefits, because billions of dollars in contributions would flow into the system in that year and in every year thereafter. In the unlikely event that no legislative changes are made between now and then and the trust funds are depleted, it will be necessary to either increase payroll taxes starting in that year or to reduce pension benefits substantially. The current estimate is that a balance of revenues and pension benefits could be achieved through either a 26 percent reduction in the pension benefits starting in 2040 (increasing to 30% by 2080) or an increase of the payroll tax by 5.1 percentage points (split evenly between employers and employees) starting in the same year (increasing to 6.3 percentage points by 2080). It is more likely that the gap would be filled by a combination of a benefit reduction of about
half this size paired with a payroll tax increase of about half this size. However, even these changes would not keep the Social Security Trust Funds in balance indefinitely into the future. Over subsequent decades, it would likely be necessary to gradually phase in some combination of additional benefit cuts and payroll tax increases. All reputable Social Security analysts and commentators agree that by about 2040 the Social Security program will be facing a serious funding problem unless steps are taken between now and then to deal with the situation.

Is Social Security facing a funding "crisis," or is it facing a funding shortfall calling for modest reforms? The answer experts give to this question tends to reflect their political ideology, particularly with respect to social welfare issues. Both those on the right and those on the left believe they are being objective, and both believe people with opposing views are allowing their ideological beliefs to distort their perception about the seriousness of future funding problems and about the viability of various proposed solutions to the problem. This debate is part of the ideological contest between those on the right, who are seeking to reduce projected future increases in public spending on Social Security, and those on the left, who want to reform Social Security in such a way as to maintain its traditional structure and objectives.

The goals of this chapter are (1) to review the history of the debate over the so-called Social Security crisis, (2) to situate this debate within the more general contest between the right and the left over how to frame discourse about Social Security reform, and (3) to present policy alternatives linked to two of the most important frames (or interpretative packages) used in the debate over Social Security reform. In my discussion of policy proposals reflecting the generational-equity frame, I will focus on proposals suggested by a commission (President's Commission, 2001) set up by President George W. Bush. In my discussion of proposals reflecting the generational-interdependence frame, I will focus on proposals made in a recent book by Peter Diamond and Peter Orszag titled Saving Social Security (2004).

The Origins of the Debate over the Social Security “Crisis”

The so-called Social Security crisis has a long history. People on the right have been using this term since the late 1970s to describe both short-term and long-term projected shortfalls in Social Security funding. It was used in the debate leading up to the 1977 Social Security reforms and then again in the de-
bate leading up to the 1983 Social Security reforms (Kingson, 1984; Williamson and Watts-Roy, 1999). Over the past 20 years the expression has continued to be employed, particularly in op-eds, and in the popular press more generally. However, it is of note that this expression has been used almost exclusively by those on the right. People on the left describe the same long-term projections in different terms. They have used such expressions as “projected funding shortfall” to label the same evidence with respect to the Social Security deficit currently projected to emerge in about 2042 if no policy changes are made between now and then other than those already legislated. The disagreement has been more over how to label these projected deficits than over their actual size.

What is going on? My interpretation is that Social Security commentators on the right prefer to use strong language in an effort to hype the seriousness of the problem so as to generate political support for their agenda, which is to introduce major structural reforms in Social Security designed to reduce its role as a source of retirement income in favor of some form of partial privatization. Given the pervasive popularity of Social Security as it is currently structured, the general public must first be convinced that the program really is in a state of crisis if they are to take seriously the rhetoric from the right calling for radical reforms. Social Security commentators on the left, in contrast, have responded by using language suggesting that the projected financing problems can easily be dealt with using a series of modest reforms that will retain the basic integrity of the current structure of the program.

During the early years of this debate, much of the effort from the right was aimed at convincing the general public that Social Security benefits to current retirees should be reduced or at least not allowed to grow in accordance with existing projections (Ferrara, 1982; Longman, 1982). One reason given was that when the baby boom generation retires, the program will go bankrupt (or in a slightly less polemic version of the argument, that it will be necessary to radically reduce benefits or radically increase payroll taxes) because of the projected spending bulge associated with the retirement of these boomers (Chakravarty and Weisman, 1988; Fairlie, 1988; Longman, 1985, 1987). The taxing power of the U.S. government, which could and would be used to prevent Social Security from going “bankrupt,” was not mentioned; instead the analogy was frequently made to a family that exhausts its savings account by poor money management over the years. Eventually efforts by commentators on the right met with considerable, but not complete, success. They managed to convince a huge fraction of the population that the Social Security system was at high risk of going
bankrupt. The critics of Social Security were successful in their efforts to undermine confidence in Social Security, but they were much less successful in their efforts to undermine support for the program (Reno and Friedland, 1997). This latter objective has long been and remains the ultimate goal for many of the most conservative analysts and commentators (Butler and Germanis, 1983).

During the past 15 years, there have been some shifts in the arguments made from the right in connection with the “Social Security funding crisis.” There has been much more emphasis on the need to give workers ownership rights in connection with their Social Security pensions (Borden, 1995; Ferrara and Tanner, 1998). The objective has been to respond to the Social Security funding “crisis” by redefining the goals of the Social Security program. The traditional social insurance goals have been de-emphasized and arguments have been made suggesting that the program needs to be restructured so that it is much more of a retirement savings program (Bipartisan Commission, 1995). Instead of thinking of Social Security contributions as the analog to payments made in connection with a health insurance policy, workers are urged to think of Social Security as a retirement savings account along the lines of a 401(k) plan. They are not encouraged to think about the program in terms such as shared risk or solidarity between generations. Instead they are prompted to envision the returns they are getting on their “contributions” relative to returns they would receive if those same contributions were made to their 401(k) accounts. In addition, they are often being asked to compare Social Security, a program that provides survivor benefits, provides disability benefits, and protects pension benefits from the effects of inflation after retirement, with a 401(k)-like scheme that does not include any of these major added benefits and protections.

**Framing the Debate over Social Security Reform**

During the 1980s, the “fiscal crisis” framing of the debate over Social Security reform evolved into what came to be referred to as the “generational equity” perspective on Social Security reform (Ferrara, 1985; Longman, 1985). The use of the generational-equity frame persists today, but its use has fallen off somewhat since the late 1990s (Williamson, McNamara, and Howling, 2003). This framing of the debate over Social Security reform proved to be useful as a vehicle linking the idea of a fiscal crisis to the idea that at least partially privatizing Social Security would be a sensible response to that crisis. In the follow-
ing two sections I analyze the ideological contest between this "generational equity" frame on the right and an alternative "generational interdependence" frame that evolved as a response to the generational-equity frame from its critics on the left.

For the most part, what has come to be referred to as the generational-equity debate has taken place in the mass media, particularly the print media. The media provide a series of arenas, such as editorials and political cartoons, in which opposing camps put forth their perspective on the debate (Gurevitch and Levy, 1985). Because the mass media often report social issues as "crises," they are prone to interpret evidence of a projected funding shortfall in Social Security as a crisis. By framing programs such as Social Security and Medicare as being in crisis, advocates of the generational-equity perspective are attempting to create pressure for immediate and fundamental structure changes to these programs.

*The Generational-Equity Framing of the Debate*

At the heart of the generational-equity interpretative package is the idea that each generation should provide for itself (Beard and Williamson, 2004). Proponents of this perspective offer a way to view old-age policy that often leads to proposals to cut back on entitlement programs for elderly people and to place more emphasis on privatized alternatives such as the partial privatization of the Social Security program. Beginning in the mid-1980s, advocates of what has come to be referred to as the generational-equity perspective argued that there was a conflict of interest between elderly people, on the one hand, and the working-age population and/or their children, on the other. These advocates included a number of analysts linked to conservative think tanks such as the Olin Foundation and the Cato Institute and journalists associated with conservative magazines such as the *National Review* and conservative newspapers such as the *Wall Street Journal* (Williamson, McNamara, and Howling, 2005). This network also came to include some organizations formed specifically to advocate on behalf of public policies linked to the generational-equity perspective. Of particular note in this context was Americans for Generational Equity, founded by Senator David Durenberger and funded by several conservative foundations and large corporations (Binstock, 1999; Quadagno, 1989).

The writing of the well-respected demographer Samuel Preston (1984) was extensively cited as a source of scientific support for the generational-equity perspective. He presented evidence that the economic status of elderly people
had been improving while that of children had been deteriorating in recent decades. His interpretation of these data was that, at least in part, the improving economic status of elderly people had been achieved at the expense of a decline in the economic status of children. From the generational-equity perspective, because of overly generous spending on elderly people in connection with Social Security, Medicare, and other programs for older Americans, young adults and children were being shortchanged.

The generational-equity frame combines the ideas of fairness and affordability (Marmor, Cook, and Scher, 1999). Proponents make five central arguments that go a long way in defining the perspective. First, they argue that whereas a few decades ago elderly people were often poor, today most are financially secure (Chakravarty and Weisman, 1988; Longman, 1987). While the assertion is true as far as it goes, it ignores or at least de-emphasizes the heterogeneity in the economic status among subgroups of the elderly population (Crown, 2001).

A second major claim made by advocates of the generational-equity frame is that affluent elderly people are getting more than their fair share of societal resources at the expense of young adults and children (Fairlie, 1988). According to this argument, the increase in federal spending on elderly people has contributed to an increase in the poverty rate for children. Critics of this perspective argue that there are many factors that have been contributing to the increase in poverty rates among children, factors that are quite independent of trends in the economic status of elderly people; one example is trends with respect to the prevalence of single parent households (Moody 1998).

Advocates of the generational-equity frame make a third argument, that a range of policies that are unfair to working-age adults and children have thrived due in large part to the political influence of old-age interest groups such as AARP (Fairlie, 1988; Longman, 1989). The claim that elderly people use their political power to promote unfair policies is loosely rooted in fact, since elderly people do form a larger percentage of the electorate today than do young adults and families with children (Binstock, 2000).

A fourth claim made by advocates of the generational-equity frame is that current old-age policies are unsustainable because of the nation’s changing demographic structure. As the population ages, they argue, these policies will become unaffordable (Concord Coalition, 1993). Critics of this perspective agree that the dependency ratio of elderly people has increased, but they go on to
point out that the dependency ratio for children has decreased (Marmor et al., 1999).

Finally, the fifth argument advocates of generational equity often make is that it is unfair to expect each generation to support the one that precedes it (Borden, 1995; Gokhale, Page, and Sturrock, 1999). If today’s working-age adults cannot count on the same level of Social Security and Medicare benefits when they retire as their parents’ generation receives today, the pay-as-you-go system is unfair. This argument is often used to support proposals calling for the introduction of privatized individual accounts as part of the Social Security system. The claim that old-age policies are unsustainable and unfair does not take into account the possibility that some relatively modest policy changes could prevent projected financing problems (Baker and Weisbrot, 1999).

The generational-equity frame has appeals to many Americans because it resonates so well with several of the most strongly and widely held values in American culture, such as individualism, autonomy, and self-reliance. Advocates of generational equity are generally not opposed to redistribution within families or voluntary redistribution in the context of charitable giving, but they oppose “mandatory” redistribution through government programs. Social Security by this argument infringes on individual freedoms and undermines incentives for citizens to consume less during their working years and to set aside the funds they will need to remain economically independent during their retirement years.

*The Generational-Interdependence Framing of the Debate*

Central to the generational-interdependence interpretative package is the idea that it is a mistake to privilege generational equity over other important forms of equity (Williamson and Watts-Roy, 1999). The generational-interdependence frame emerged largely as a liberal response to the conservative generational-equity frame. In addition to taking issue with a number of the claims made by advocates of the generational-equity frame, the generational-interdependence frame makes three distinctive claims.

The first is that the gains of one generation are not necessarily made at the expense of another (Kingson, Hirshorn, and Cornman, 1986). Robert Kuttner (1982), for example, mentions the ways in which the existence of Social Security benefits the children of elderly parents by making it possible for the elderly parents to maintain their independent households. Similarly, Joseph White
(2001) points to the relief Social Security provides to workers who, because of it, need not be concerned about their parents falling into poverty. Even with Social Security structured as it is today, some adult children find it necessary to take in their elderly parents. This practice would become even more common if we as a nation opted for a much diminished version of Social Security. Not only do those who are not elderly benefit from many programs often viewed as programs for elderly people, such as Social Security and caregiving services, but also many programs typically viewed as programs for those under age 62 benefit elderly people (for example, unemployment insurance and Medicaid).

The second claim is that there is a two-way flow of services and support between generations. The flow of financial resources in many families is primarily in the direction of the adult children until the elderly parents reach extreme old age. Many elderly people provide substantial caregiving services for their grandchildren or disabled adult children (Smith and Beltran, 2000).

The third distinctive claim is that elderly people are much more heterogeneous than implied by the opposing generational-equity frame. Some elderly people are affluent, but many are poor or nearly poor. It is also pointed out that the generational-equity frame focuses on one form of equity to the neglect of other important forms of equity, such as those based on gender, class, and race. In short, economically vulnerable groups tend to be neglected by the generational-equity frame; the generational-interdependence frame represents an effort to address this limitation (Adams and Dominick, 1995; Binstock, 1983; Kingson and Williamson, 1993).

**Linking Ideological Frames and Policy Prescriptions**

I have described the ways in which the contest between proponents of the generational-equity frame and proponents of the generational-interdependence frame shaped the debate over Social Security reform, particularly between the early 1980s and the mid-1990s. During the past decade or so the debate over generational equity has largely morphed into a debate between proponents and critics of the proposed partial privatization of Social Security. In the following two sections I present and briefly analyze two alternative sets of policy prescriptions for the reform of Social Security, one from each of these two perspectives. The conservative policy prescriptions are often defended using arguments linked to the generational-equity frame, whereas the progressive
policy prescriptions are frequently defended using arguments linked to the generational-interdependence frame.

Given the sharp differences between these two competing conceptual frameworks, it should not be surprising to find that the policy prescriptions that emerge from proponents of these different perspectives differ dramatically. From the right the call is to restructure the Social Security program so as to gradually redefine it as primarily a retirement savings plan. As one example reflecting this perspective I will consider two of the major proposals made by the President’s Commission to Strengthen Social Security as outlined in its 2001 report. In the other camp are those on the progressive left who favor efforts to retain Social Security as a broad-based social insurance program. They generally do not favor the creation of funded individual accounts, and they are reluctant to introduce changes that are likely to increase the burden on low-wage workers relative to higher-wage workers. As one example of this progressive perspective, I will consider a set of proposals made in a Diamond and Orszag’s recent book (2004).

Conservative Policy Prescriptions: Social Security as Retirement Savings

Commentators and analysts associated with the conservative Cato Institute began to call for the privatization of Social Security during the early 1980s (Ferrara, 1982, 1985). Until the mid-1990s, the call to privatize Social Security did not get much attention; it was viewed as a political nonstarter associated with the radical right. But there was a dramatic shift in attitudes on this issue by the mid-1990s (Kingston and Williamson, 2001). By then, proposals calling for partially privatizing Social Security had been presented and vetted by two mainstream commissions: the Bipartisan Commission on Entitlement and Tax Reform (1995) and the Advisory Council on Social Security (1997). Both of these reports got a great deal of coverage in the media. More recently, the President’s Commission to Strengthen Social Security (President’s Commission, 2001) in its final report (hereafter called Commission Report) outlines additional alternatives for the partial privatization of Social Security. I will focus on the most recent set of proposals outlined in this report.

The first proposal would allow workers to redirect 2 percentage points (out of 6.2) of their payroll tax into personal accounts. When the worker retired, the Social Security pension based on the regular (or defined benefit) portion of the scheme would be lower owing to the diversion of a portion of the payroll tax
into the new personal account. This plan calls for the addition of about $1.1 trillion in additional funding from general revenues between 2016 and 2043 to finance the transition. Even after 2043, the plan would still continue to run a deficit that would have to be made up in some way, but the deficit would be lower than that projected for the current scheme.

The second proposal would allow workers the option to redirect 4 percentage points of their payroll tax into personal accounts, but there would also be a cap of $1,000 per year on the amount that could be so diverted. At retirement the defined benefit portion of Social Security would be greatly reduced as a result of the diversion of this substantial fraction of the worker’s payroll tax into the personal account. After 2009 there would be a shift from wage indexing to price indexing of the covered income used to compute the defined benefit portion of the benefit. This would add up to a huge benefit cut. A guaranteed minimum income would be added to help protect low-wage workers who would otherwise end up with very low pensions. If the worker’s combined income from the defined benefit component and the personal accounts component were to fall below 120 percent of the poverty line, the difference would be made up by the government out of general revenues. The proposal calls for an infusion of about $900 billion between 2015 and 2029 from general revenues to help finance the transition.

The third proposal would allow workers to redirect 2.5 percentage points of their payroll tax into personal accounts, subject to a cap of $1,000 per year, but they would also need to add another 1 percent of their wages to these personal accounts. Again the defined benefit portion of the eventual pension would be reduced by an amount that reflects the extent of the diversion of payroll contributions into personal accounts. These pensions would also be further reduced by the proposed shift from wage indexing to price indexing of the pre-retirement wages used to compute the pension benefit. The proposal would increase the incentives for those who delay retirement (a reform that would end up affecting few workers) and increase penalties for those electing early retirement (a reform that would affect a lot of people). There would be a guaranteed minimum pension this time set at 100 percent of the poverty line. This proposal would require the infusion of approximately $400 billion in new money from general revenues between 2015 and 2028 to help pay for the transition. After this transition period there would still be a gap between benefits and revenues, but the gap would be less than that under current law.

In the comments that follow, I focus on proposals 2 and 3, since proposal 1
is at best a partial proposal. While both proposals 2 and 3 have their flaws, they also include a number of innovations. One innovation is to make participation in the personal accounts voluntary. Based on the British experience, this would help protect low-wage workers, many of whom would opt for the defined benefit option (Williamson, 2002). However, there is a catch. Both proposals 2 and 3 call for indexing changes that would result in substantial benefit cuts, changes that would impact all workers, not just those who elect the personal-account option.

The introduction of a rather generous minimum pension for proposal 2 (and a slightly less generous minimum pension for proposal 3) is another important innovation. The proposed minimum pension, modest as it is, would go a long way toward protecting many of the most vulnerable. However, here too there is a catch: this minimum pension would only become available after 30 years of participation, thus excluding many of the most vulnerable. Another concern I have is that in any final legislation, the minimum pension would be cut substantially and possibly eliminated entirely. There is a real risk that the groups that would be most dependent upon and affected by this provision would not be well represented when the final deal is cut behind closed doors. Another reason for concern is that the need for huge sums to pay for the transition costs associated with these reforms is likely to produce intense pressure to cut any benefits without a strong constituency. In addition, it is generally easier to cut proposed new benefits than it is to cut benefits that people have been receiving (or promised) for years.

Proposal 3 calls for splitting pension assets in the event of divorce. This innovative provision would benefit women who have been married for many years to high-wage spouses. However, it would not be of much help to women in low-wage households or those not legally married to their partners.

The Commission Report (President's Commission, 2001) does not give adequate attention to the issue of market risk or the consequences of being subjected to a sharp drop in financial markets during the months or years just before retirement. While a legitimate case can be made that the ups and down of the stock market tend to average out over a period of decades, risk is a big issue particularly for low-wage workers because they often end up so close to the poverty line that even a modest drop in benefits may push them into poverty. In addition, low-wage workers are much more dependent on Social Security for their retirement income than are the affluent, the ones who are the most enthusiastic about the introduction of personal accounts (Williamson, 1997).
Each of the three plans calls for a large infusion of funding from general revenues for a period of about 15 to 25 years to pay for the cost of the transition. This is extra funding that would be needed to meet Social Security obligations to the currently retired and disabled while diverted payroll taxes were being used to build up individual accounts. From the British experience, it is safe to assume that in the long run partial privatization would reduce the burden on the government (Liu, 1999), but in the short-term (15 to 25 years depending on the plan) the burden on the government would increase substantially.

Under both proposals 2 and 3, the shift from wage indexing to price indexing of preretirement earnings would bring about a major cut in Social Security benefits. When the extent of these cuts is made explicit, it is probably going to create major political problems for those attempting to build support for these privatization proposals.

*Progressive Policy Prescriptions: Social Security as Social Insurance*

The primary policy prescription that can be derived from the generational-interdependence framing of the debate over Social Security policy is that the emphasis should be on maintaining the program pretty much as it is. There is a recognition from this perspective that some changes will be necessary to bring the program into long-term financial balance, but the goal seems to be to keep the resulting program as close as possible to what we have today. Analysts from this perspective implicitly or explicitly emphasize that Social Security is a social insurance program, not a retirement savings program. While a social insurance program can be expected to provide income replacement for older workers, the emphasis is different. Such a program does not take as its primary objective obtaining the highest possible long-run return on payroll tax contributions made in the worker’s name, and it is not structured so that pension benefits are strictly proportional to contribution.

Social insurance schemes have been created to cover a number of risks to income in modern societies, including disability, work injury, and the loss of income associated with old age and retirement. These schemes start with the assumption that in a modern market economy the risks and the benefits are unequally distributed and that some collective protection is needed for those who do not fare well. Social insurance is based in part on the assumption that workers who take the risks associated with a competitive economy need a certain level of collectively provided economic security (Dionne, 1999).
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Given that there is a projected deficit for the Social Security program starting in 2042, even those who want to maintain Social Security much as it is recognized that some reforms are called for. One simple alternative would be to gradually raise the payroll tax. Were that done, it would be possible to meet the anticipated burden without any other changes in the program. The payroll tax may eventually have to increase by at least 3 percent for both the employer and for the employee by 2080 (Board of Trustees, 2006), but the total burden would still be lower than it is today in some European nations, such as Sweden. There are some analysts who support this alternative (Thompson, 2000), but most of those who represent the progressive social insurance framing of this debate reject this solution. Many believe that a call for a tax increase of this magnitude would not be politically viable. They also believe that it is unfair to put the entire burden on people in the labor force. While there may be disagreements with respect to how much of the burden should be borne by the retired as opposed to those who are still at work, there is general agreement among those in this camp that some sort of burden sharing is called for. One way to do this is to make a number of modest policy changes that produce a balance between benefit cuts and payroll tax increases.

A good example of a balanced set of policy changes is presented in Saving Social Security, by Peter Diamond and Peter Orszag. Their proposals are structured to deal with three sources of the projected long-term deficit in Social Security: (1) increasing life expectancy, (2) increasing inequality in earnings, and (3) the legacy debt, the part of the projected debt that can be attributed to the generous benefits paid to early participants relative to the contributions they made before retirement. Their proposed reforms combine both tax increases and benefit cuts. President Bush's Commission to Strengthen Social Security proposed that we deal with the projected increase in life expectancy primarily by cutting benefits. Diamond and Orszag (2004), in contrast, offer an alternative that balances benefit cuts and payroll tax increases. Their alternative calls for an annual recomputation of the life tables and of the projected increases in the cost of the Social Security program due to any increase in life expectancy at the age at which a worker becomes eligible for a full (as opposed to a reduced) Social Security pension. Half of the projected increase in the cost of Social Security due to the increase in life expectancy would be dealt with by reducing the size of the worker's initial monthly retirement pension, based on his or her earnings history at retirement. The other half of the projected increase in the
cost due to the change in life expectancy would be dealt with by a modest increase in the payroll tax. This matched pair of reforms produces a relatively even split between the tax increase and benefit reduction over the long run.

The last major changes in Social Security policy were made in 1983. At that time, approximately 10 percent of all earnings were untaxed because they fell above the taxable maximum, the earnings level above which earnings are no longer taxed. By 2002, owing to the increase in income inequality (increases in earnings for those at the top of the income distribution relative to those at the lower end), approximately 15 percent of earnings were above this taxable maximum. One consequence of this shift is that the system is less progressive today than it was 20 years ago. Another is that today Social Security is projected to replace less of preretirement income in the decades ahead than it replaces today. This shift in the fraction of all earnings that are above the taxable maximum ($87,900 for 2004) is also part of the reason for the projected long-term deficit. The Diamond and Orszag proposal for dealing with this source of the deficit is to gradually increase the level of the taxable maximum until the percentage of earnings above the taxable maximum gets back up to 13 percent. I would suggest at a minimum moving it all the way back to 10 percent, but their desire to keep a balance between the extent to which benefits are cut and revenues are increased leads them to prefer the 13 percent figure, which turns out to be about the average level over the past 20 years.

The benefit cut Diamond and Orszag propose to balance the preceding tax increase is to make the payout formula used to compute Social Security pensions more progressive by gradually decreasing the size of the benefit for relatively high-wage workers, who currently get only a 15-cent increase in pension benefit for each additional dollar of AIME (average indexed monthly earnings), the income figure Social Security uses to compute the worker’s PIA. Their proposal is to gradually decrease it to 10 cents for each additional dollar of AIME for this group of high-wage workers. This same reform was proposed in connection with one of the three plans outlined by the President’s Commission to Strengthen Social Security. Given the support for the idea in the Commission Report (President’s Commission, 2001), it is likely that bipartisan support could be found for this proposal.

The third source of the projected Social Security deficit that Diamond and Orszag deal with is the legacy cost, the current and future costs due to benefits to early Social Security recipients that were in many cases far in excess of what could be justified on the basis of contributions to the program made before re-
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tirement. They estimate that between 3 and 4 percentage points of the 12.4 percent payroll tax is due to the need to finance this legacy debt. They propose three reforms to deal with this source of the projected deficit.

One is to require that all workers participate in the Social Security system, including those state and local government workers not currently enrolled in Social Security. Because many state and local pension schemes are more generous than Social Security, it would be politically easier to make these changes gradually, for new hires only. This proposal makes sense and it should be done. It is likely that there will be bipartisan support for this idea.

A second reform proposal designed to deal with the legacy debt is to add a new 3 percent tax on all earnings above the maximum taxable earnings specified under current law ($87,900 for 2004). Over time it is likely that this tax would have to be increased somewhat to keep up with the legacy debt. It is of note that this proposed tax would be about equal to the current Hospital Insurance component of Medicare, which is already financed on the basis of all earnings including those above the maximum taxable earnings limit. This proposal would be a good idea, but it is likely to run into strong political opposition from an influential segment of the population, those with high incomes. It might be more feasible politically to increase the taxable maximum to the level needed to bring in the same amount of revenue. In my view a new tax on the affluent is going to be harder to sell than increasing the taxable maximum more than is called for on the basis of inflation adjustments alone.

The third reform they propose is a “universal legacy charge.” It calls for a reduction in pension benefits and an increase in the payroll tax. The benefit reduction for newly eligible beneficiaries calls for an additional 0.31 percent reduction each year starting in 2023. Thus, in 2024 the reduction would be 0.62 percent (relative to current law). The corresponding revenue increase (that would balance the 75-year actuarial effect of the benefit reductions just outlined) would take the form of a payroll tax increase sufficient to increase revenues by 85 percent of the amount saved from the reduction in pension benefits each year. This tax rate increase would be 0.26 percent (85% of the .31% benefit reduction each year) each year starting in 2023. Diamond and Orszag suggest that this set of benefit and revenue adjustments be reviewed and appropriate modifications made in each after 75 years. If history is any guide, such adjustments would most likely be made much sooner. This is a proposal that I would support, and I believe that it would make sense as part of a balanced program, but I fear that the prospect of the steady increase in the payroll tax called
for is likely to generate a substantial amount of political opposition. The proposal to hold off starting the process of increasing the payroll tax until 2032 would help politically, particularly with older workers. Something along these lines might be politically feasible, but it might be a hard battle.

What I have outlined is a summary of the three major components of the Social Security reform plan outlined by Diamond and Orszag (2004). It is also of note that they go on to offer an alternative for one or more of the proposals that they have made. The alternative is to use the estate tax as an additional source of funding for Social Security. The Tax Relief Reconciliation Act of 2001 calls for reductions in the estate tax over the years and for the complete elimination of this tax as of 2010. However, without further legislation, that estate tax would return to its 2001 level the following year, an outcome that few expect will be politically acceptable. What Diamond and Orszag propose is that the estate tax be retained in the form it will have in 2009, that is, the tax would be at the level of 45 percent on the 0.5 percent of estates that are above $3.5 million. This source of revenue would then be used exclusively to help fund Social Security. A related proposal is to close existing loopholes in the estate tax. They also consider transforming the estate tax into an inheritance tax. The difference is that were it made into an inheritance tax, then the person who inherits the estate would pay the tax rather than the estate, but again the revenues would be earmarked to help fund Social Security. The idea of financing old-age pensions using an estate tax is not a new one. It is reported to have been suggested by Thomas Paine in 1797 (Diamond and Orszag, 2004).

Would it make sense to dedicate that portion of the estate tax that remains in 2009 to helping shore up Social Security? It would represent a shift from Social Security's long history of being financed entirely on the basis of a dedicated payroll tax. Many people would view it as a radical shift and would oppose it. However, the source of the funding might mute the opposition for two reasons: (1) it would not come from general tax revenues, and thus the number of people paying this tax would be limited, and (2) it would not be a new tax; rather it would be a tax the very rich are already paying. However, if this money is diverted into the Social Security system, how is the reduction in general government revenues to be made up? I would guess that the major alternative would be to increase income taxes. In the likely event that such a link would be made, political support might be undercut. While it would put the tax entirely on a relatively small segment of the population, the very wealthy (or, more precisely, their estates), this also happens to be a politically influential segment of the
population, so the opposition could be fierce. How about the idea of transforming the estate tax into an inheritance tax? The major problem is again potential political opposition. At issue would be the view that it is a new tax, and it is always hard to get political support for a new tax.

A distinctive aspect of the set of proposals made by Diamond and Orszag is the way in which they divide the projected shortfall into three different sources and then provide a balanced set of benefit cuts and payroll tax increases to deal with each of these sources. The way in which they provide a balance between benefit cuts and payroll tax increase for each of the three sources of the projected deficit is going to make the package attractive to many policy analysts.

One of the most innovative aspects of their analysis is the inclusion of a set of reforms to deal with the legacy cost. I think many analysts are going to take an interest in the "universal legacy charge" they propose as part of the legacy cost problem.

While Diamond and Orszag's careful balancing of pension benefit cuts with payroll tax increases is a major strength that is going to contribute to the political viability of their proposals, this balance does not come without a cost. I would like to see the cap on the level of earnings subject to the Social Security payroll tax removed, as it already has been for the Hospital Insurance component of Medicare. I would also like to see earnings based on the exercise of stock options taxed as wage income when part of the employee's compensation package. But such reforms would violate the balance between payroll tax increases and benefit cuts that Diamond and Orszag (2004) so carefully crafted.

Conclusion

Is Social Security facing a substantial funding shortfall unless some modest tax increases and benefit cuts are made over the next few decades, or will it be facing a funding "crisis" unless fundamental structural changes are made—and soon? Many on the right who, for a variety of reasons, favor a radical restructuring of the program often use the crisis framing of the debate in an effort to build support for their proposals. Strong language is employed in an effort to undermine confidence in and support for what is arguably the nation's most popular social program. In contrast, many on the left who prefer to reform Social Security in such a way as minimize structural changes tend to use different language when describing the projected funding shortfall. Those on the right tend to use an interpretative package that emphasizes arguments linking Social
Security policy to such themes and values as individualism, self-reliance, personal freedom, and ownership. This is often referred to as the generational-equity perspective. Those on the left often use an alternative interpretative package that emphasizes a different set of themes, such as social insurance, shared risk, generational interdependence, and societal obligation to protect vulnerable groups from the sometimes harsh consequences of a market economy. This is often referred to as the generational-interdependence perspective. The debate between the right and the left over the future of Social Security is a symbolic contest being waged largely in the popular media, using carefully chosen metaphors and catch phrases designed to sell each interpretative package to as wide an audience as possible.

The generational-equity perspective has been used to build the case for a number of Social Security reform packages, the most widely discussed being those that have included a funded individual-account pillar (component). In this chapter I have presented and commented on one of the most recent sets of proposals, those outlined in the Commission Report prepared by the President’s Commission to Strengthen Social Security (2001). The various proposals outlined in the Commission Report include a number of innovative ideas that subsequent commissions would do well to consider and others that are likely to prove seriously problematic. The proposed individual accounts would likely benefit some if not many affluent workers, but at a cost. These same proposals would not do an adequate job of providing protection for those economically vulnerable groups that are most dependent upon Social Security pensions for their retirement income.

The generational-interdependence perspective has been used to build the case for a number of more progressive Social Security reform packages that give much more attention to the social insurance function of the program. Here I have presented and commented on the policy suggestions suggested in a recent book by Diamond and Orszag (2004) to illustrate the different policies that have been proposed from this alternative progressive perspective. In this case, the focus has not been on one major policy, such as the introduction of individual accounts; rather it has been on the creation of a basket of more modest reforms that leave the current structure of Social Security very much intact. These reforms have been carefully constructed so as to balance the burden of dealing with the projected deficit between future retirees and future workers, a balance between provisions that lead to modest benefit cuts and modest payroll tax increases without the introduction of funded individual accounts.
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It is easy to take issue with one or another of the many policy changes that Diamond and Orszag proposed, but in so doing it is important not to miss a much more important point. Their major contribution has been to show how the long-term Social Security funding gap can be closed in such a way that the burden is evenly divided between individuals in the labor force and individuals who are retired. Furthermore, they show us how to achieve this goal without calling for the partial privatization of Social Security.

NOTES

1. Unless specified otherwise, the material presented here is drawn from chapter 5 of Diamond and Orszag 2004.

2. The payroll tax would be increased by the amount necessary to equal 85 percent of the decrease in the PIA (primary insurance amount), the pension benefit a worker is eligible for if she or he takes the pension at the age of eligibility for the full retirement benefit. See Diamond and Orszag (2004) for an explanation of why the 85 percent figure is used.

3. See note 2 for a definition of PIA.

REFERENCES


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