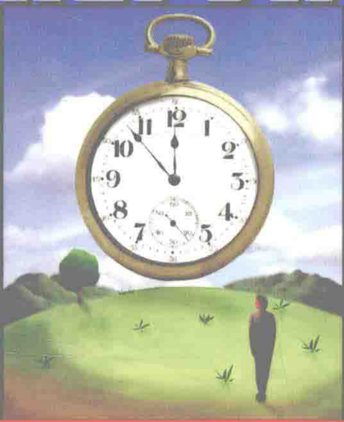
A CENTURY FOUNDATION BOOK

COUNTDOWN TO REFORM



THE GREAT SOCIAL SECURITY DEBATE

REVISED AND UPDATED FOR 2001

HENRY J. AARON

ROBERT D. REISCHAUER

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Countdown to Reform

FOREWORD

Compared to other rich nations, the United States does not provide very generous public programs for the elderly. The basic safety net, composed of Social Security and Medicare, for example, supplies lower benefit levels than those available in Western Europe. But these programs comprise the largest domestic activities undertaken by the U.S. government, touching more lives directly than anything else—save the income tax and the postal service.

Social Security especially has tended to operate with relatively little controversy, routinely accomplishing the task for which it was created—reducing poverty among the elderly. Without it, in fact, more than half of Americans over age 65 would fall below the poverty line. Now, however, with the retirement of America's largest generation—the baby boomers—in sight, both Social Security and health programs for the elderly are quickly moving to center stage in political and policy debates.

At one extreme, some are convinced—and they are trying hard to convince others—that more old people will be no blessing for the nation. They argue that America might be doomed to a sharply diminished future unless extreme steps are taken to change the way we provide for our aged. Others advise a more moderate course, adjusting burdens and benefits within the framework of the existing system. Not surprisingly, the differences in approach often reflect a more fundamental divergence on general questions about the proper role of government and about the interaction between market capitalism and the lives of individual citizens.

These competing ideas about how to make the necessary adjustments in retirement programs thus have become staples in broader public policy conversations in Washington and across the nation. The outcome is far from settled.

Overall, however, it seems clear that while societies everywhere are converging in a belief that high rates of economic growth and long-term prosperity are possible only with free markets, they also are learning (or, in the case of the United States, relearning) lessons about the risks that accompany free enterprise. These lessons underscore the continuing importance of building strong, democratic governmental institutions to enforce the rules of the game and to deal with the abuses of the marketplace. Moreover, the unavoidable uncertainty about the long-term outcome for any individual of a lifetime of work, savings, and investment confirms the indispensability of a reliable social safety net, especially for the young and old.

With so much at stake for so many, The Century Foundation has been supporting and publishing a wide array of analyses of the aging of America. On Social Security alone, we have published both Robert M. Ball's *Straight Talk about Social Security* and *Insuring the Essentials: Bob Ball on Social Security;* Robert Eisner's *Social Security: More, Not Less;* and multiple editions of our extremely popular Basics pamphlet, *Social Security Reform,* as well as *Beyond the Basics: Social Security Reform,* a volume of essays edited by Richard C. Leone and Greg Anrig. We also have set up a website providing information on this critical issue: www.socsec.org. We have been joined in our efforts by other organizations and individuals whose work has added to our understanding of the issues involved in retirement security.

In these efforts, a few experts stand out as exceptional for the breadth and depth of their knowledge and the fairness of their approach. Henry J. Aaron of The Brookings Institution and Robert D. Reischauer of The Urban Institute are in this elite class. The opportunity to make possible the publication in 1998 of their analysis and conclusions about how to save Social Security was one of the high points of our efforts to bring more light to this important debate. That edition of *Countdown to Reform* was published in the midst of heated arguments about the future of the program. The heady pace of the stock market then seemed to offer a sure way for all citizens to be rich—if the government would just get out of the way. The misunderstanding embedded in this sort of argument for privatizing Social Security was profound, as the volatility in the market as 2000 drew to a close has made all too clear. (Just how devastating would the effects of retiring during such a downturn be, especially to someone who had put a great deal of faith in technology stocks?) What was needed then to put the discussion back on track was an authoritative and comprehensive examination of the program and its strengths and weaknesses, as well as an assessment of the various reform proposals under discussion. Henry Aaron and Robert Reischauer fulfilled all those needs and more.

Now, in 2001, we are undoubtedly on the verge of a new and possibly even more important national debate about what to do about Social Security. It is a good bet that we soon shall be surrounded by a swirl of half-truths and outright howlers about how to "fix" the nation's premier social program. And here again, like an intellectual cavalry, are Aaron and Reischauer riding to the rescue with a new edition of their definitive work on the subject.

In the pages that follow, Aaron and Reischauer clearly lay out the basics about the impact of the boomers on the Social Security system. They sort through the major proposals that have been made to deal with the challenge of more elderly. And in an objective but blunt fashion, they assess the strengths and weaknesses of each alternative. Finally, they make a compelling case for their own synthesis of the best elements of a reform program. In one volume, in other words, there is just about everything an informed citizen needs to know about what is right and what is wrong with Social Security and how to preserve the system for the future.

In the end, of course, the authors stress that there is no magic formula that will sweep away all the issues raised by the aging of the boomers. For all but a few fortunate individuals, as well as for the nation as a whole, many questions (like life's risks in general) cannot be wished or legislated away. Given the long-term nature of the implicit contract involved in a retirement program (perhaps sixty years from the start of work to the end of life), such risks are inevitable. Over such a span, birthrates and medical progress are unpredictable, securities markets are sure to experience immense volatility, and even the most stable democracies are likely to experience sweeping transformations in politics and policy. In other words, the future development of society will remain complex and uncertain. When combined with the uncertainties intrinsic to the careers and health of individual workers, the case that the authors make for a safe and conservative social insurance program seems eminently sensible.

Social Security is far from perfect, but as the old joke reminds us, it—like old age itself—has a considerable edge over the alternatives. On behalf of the Trustees of The Century Foundation, I thank Henry Aaron and Robert Reischauer for their exceptional contribution to our thinking about how to save Social Security.

RICHARD C. LEONE, *President*
The Century Foundation
January 2001

AUTHORS' PREFACE TO THE SECOND EDITION

Since the first edition of this book appeared in December 1998, reform of Social Security has moved center stage in U.S. political debate. The major party candidates presented sharply different visions of Social Security during the 2000 presidential campaign. George W. Bush pledged repeatedly to push the introduction of individual accounts as a partial replacement for traditional Social Security. During the campaign, he said that he would earmark a portion of current payroll taxes to fund these accounts. This approach has elicited support from many Republicans and some Democrats. Vice President Gore called instead for buttressing the current system. Polls indicated that more Americans favored his position than supported Bush's. Proponents of this view point out that diverting payroll taxes from Social Security deepens the deficit in traditional assured benefits. They fear that diverting revenues will necessitate massive benefit cuts that are unlikely to be fully offset by accumulations in individual accounts.

The size of the stakes of the upcoming debate on Social Security reform can hardly be exaggerated. Its outcome will determine the form of the nation's basic pension plan for decades to come, with far-reaching economic and political implications.

Against this background, we felt it important to revise and update the first edition of *Countdown to Reform: The Great Social Security Debate*. As in the first edition, we describe major reform proposals and assign grades to them. The roster of reform plans in this second edition is almost entirely new. Some plans pass with honors, but others receive low marks or grades of incomplete—including the proposals of both major party presidential candidates. We examine the desirability of using general revenues to support Social Security or to underwrite the transition to individual accounts. We paid no attention in the first edition to this option because, as recently as just two years ago, we still found the prospect of large budget surpluses, except in Social Security, hard to take seriously. Now, a long run of budget surpluses seems likely, provided that Congress can resist passing large tax reductions and spending increases. The existence of such surpluses opens up possibilities for reform of the current Social Security system or for covering the costs of transition to a system of private accounts that did not exist when we wrote the first edition.

As in the first edition, we emphasize the importance of preserving the current defined-benefit system as the only way to assure basic income to retirees, survivors, and the disabled. We emphasize the importance of boosting national saving. We suggest that it is desirable and possible to boost the returns that workers receive on their payroll taxes. We show how to achieve that objective without incurring undesirable risks and needless administrative costs that are inescapable with individual account plans. But our main purpose is to provide information that will enable readers to judge for themselves what reforms in Social Security will best serve the interests of the nation over the coming decades.

We wish to acknowledge the financial support of The Century Foundation. We are grateful to our research assistants for help in updating and correcting the second edition. Along with all others who try to do research on the Social Security system, we are massively indebted to Stephen Goss, who was Deputy Chief Actuary during the period when we were revising the manuscript. His cost estimates are the "gold standard" on which all analysts depend, and his strict and scrupulously fair analytical observations should be ignored by no one.

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Introduction

The oldest of the baby boomers—those born between 1946 and 1964—will become eligible for Social Security retirement benefits during George W. Bush's last year in office, if he serves two terms. Three years later they will qualify for Medicare. When all the boomers have retired, roughly three decades later, more than 70 million former workers and their dependent spouses will have become Social Security beneficiaries.

Most Americans understand that Social Security's immediate situation is far from parlous. The program's income—from payroll and other tax revenues and the interest earned on the reserves accumulated in the trust fund—exceeded outlays for benefit payments and administration by a whopping $150 billion in 2000. Before the first of the baby boomers draws a benefit check, surpluses like these should boost Social Security's trust fund reserves from $1 trillion in 2000 to well over $2 trillion.

Is this merely the calm before the baby boomer storm? Clearly, no. Program income is currently expected to exceed spending until 2024. Such income supplemented by resources drawn from the trust fund's accumulated reserves should be sufficient to pay all currently promised benefits until 2037 or beyond.

But the lack of an immediate or even an intermediate-term crisis does not mean that all is well. The program faces significant longer-term deficits. These shortfalls result not just from the retirement of baby boomers, but also from the anticipated increase in life expectancies and the reduced fertility rates that will lower the growth of the future workforce that will be paying the payroll taxes that support the program. If nothing at all were done to modify the current system until the trust funds were exhausted, and if current economic and demographic projections were to prove accurate, benefits would have to be cut by about one-fourth or payroll taxes would have to be increased by about 38 percent starting in the late 2030s. By 2075 the benefit cuts would have to grow to nearly one-third or the tax increase to 50 percent to keep the program afloat.

Social Security's financial balance could be maintained for the next seventy-five years, the period used for long-run Social Security planning, by immediately implementing less drastic adjustments—trimming benefits by about 12 percent or boosting payroll taxes 15 percent. Such action *could* resolve Social Security's long-run financial problem without requiring fundamental change to the program's structure.

The dominant characteristics of financial projections, however, are their uncertainty and volatility. From 1990 to 1997 the projected long-term deficit in Social Security more than doubled. Since 1997, the booming U.S. economy has reduced it by 15 percent, and the continuing strength of the economy promises further reductions. The long-run projections are acutely sensitive to small changes in developments that are impossible to forecast reliably—how fast worker productivity will increase, how fast mortality rates will decline, what will happen to interest rates, how many children people will have, and how many immigrants will enter the United States. Were economic performance to sour, the long-term deficit could turn out to be considerably larger than current projections indicate. With continued strong economic performance and favorable trends in other variables, it could turn out to be much smaller or could even disappear.

For this reason, the United States faces a larger and much more important question than how to deal with a projected financial shortfall nearly four decades into the future. It is whether the structure of Social Security, a program that is now 65 years old and was designed for a nation radically different from contemporary America, *should* be fundamentally changed. A debate on whether a program designed during the Great Depression is still the right program for twenty-first century America would be worthwhile even if Social Security's long-term finances were entirely adequate. When Congress passed the