

Social Security Reform
Peter R. Orszag¹
Joseph A. Pechman Senior Fellow in Economic Studies
The Brookings Institution

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Mr. Chairman and other members of the Committee, thank you for inviting me to testify before the Committee this morning. Social Security provides the foundation of retirement income, but must be combined with other saving to achieve full retirement security. Retirement income should thus be viewed in terms of tiers, with Social Security delivering a core tier of protection upon which additional retirement income must be built. Figure 1 illustrates these tiers assuming a target for retirement income equal to 70 percent of pre-retirement wages, a replacement rate that is often recommended by financial planners.

Figure 1: The tiers of retirement income

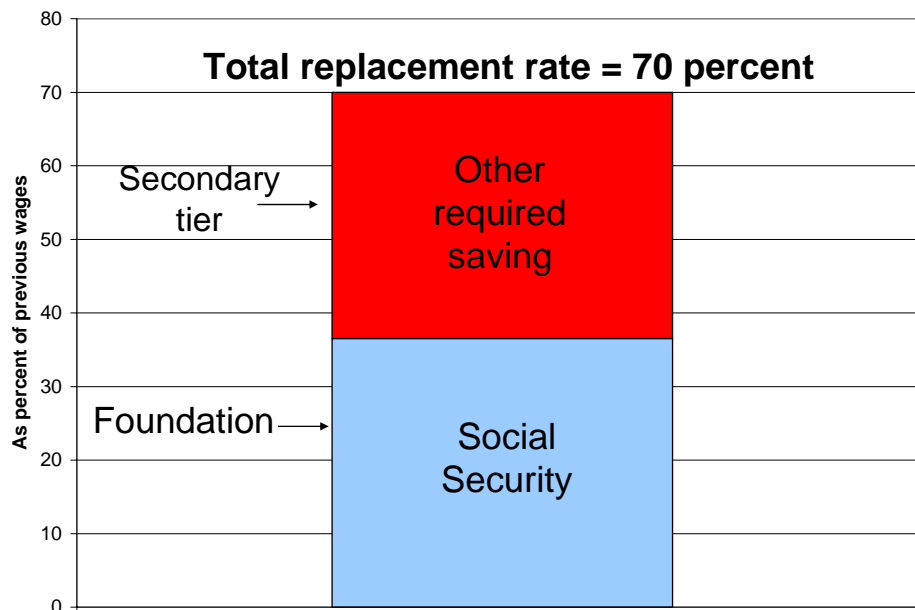


Figure 1 shows initial replacement rates at retirement (that is, retirement income relative to previous wages) for medium-earning worker claiming benefits at age 65 in 2054

Both tiers of retirement security face challenges. In that context, my testimony makes four main points:

¹ The views expressed here are those of the author alone. This testimony draws upon joint work with Peter Diamond, Jason Furman, William Gale, Robert Greenstein, and Mark Iwry. I also thank numerous other colleagues for helpful discussions and comments.

- **Retirement security can be significantly enhanced by improving 401(k)s and IRAs through commonsense reforms that both sides of the Social Security debate should embrace.** The individual accounts we already have -- in the form of 401(k)s and IRAs -- can be substantially improved and strengthened through a series of commonsense reforms that would make the pension system easier to navigate and more rewarding for American families. In the face of the difficult choices presented by the current system, many people simply procrastinate, which dramatically raises the likelihood that they will not save enough for retirement. Disarmingly simple concepts -- such as changing 401(k) plans so that workers are automatically enrolled unless they opt out, and making it easy to save part of an income tax refund -- have the potential to strengthen retirement security significantly. Both sides of the Social Security debate should agree on the straightforward steps necessary to improve 401(k)s and IRAs, and should come together to enact the changes immediately.
- **Although improving the accounts we already have on top of Social Security makes sense, introducing accounts within Social Security does not.** Under the Administration's proposal for accounts *within* Social Security, workers receive payroll revenue today, but pay the payroll revenue back, plus interest at a 3 percent real rate, at retirement through a reduction in traditional Social Security benefits. In effect, the individual accounts represent a "Social Security line of credit." Workers drawing upon that line of credit have payroll revenue deposited into their individual account today, but then owe the funds back, plus interest, once they retire. The system is thus similar to a loan from the government to workers.

At best, assuming that all the loans carry the government's borrowing rate and are fully repaid, the accounts do nothing to improve solvency within Social Security over the long term -- as even the White House has acknowledged. A more likely scenario is that some of the loans will not be repaid in full, in which case the accounts harm solvency, even over an infinite horizon. And even if they are actuarially neutral over the long term, the accounts create a massive cash-flow problem in the meanwhile.

Some argue that the accounts would facilitate other changes -- especially benefit reductions for higher earners -- that would help to restore long-term balance to Social Security. But it is hard to see why, unless they were subsidized, the loans should be particularly attractive, especially to higher earners. Indeed, a Goldman Sachs analysis recently concluded that, "In essence, the 3% real rate offset represents a loan from the federal government to the accountholder to fund the personal saving account. This is not an attractive proposition."² Higher earners who typically already own a mix of stocks and bonds should find little or no value in unsubsidized loans from the government. And if the accounts were subsidized to make them more attractive to higher earners, their direct effect would be to *expand* the Social Security deficit. Increasing stock ownership among moderate and lower earners is desirable, but not by encouraging them to borrow against their future Social Security benefits. Instead, a better approach to increasing equity ownership and retirement saving for such households are the commonsense changes to 401(k)s and IRAs described above.

² Goldman Sachs, "Daily Financial Market Comment," February 23, 2005.

Reducing traditional Social Security benefits to make room for individual accounts would also be unsound for society as a whole, since it would decrease the core tier of retirement income that is protected against financial market fluctuations, inflation, and the risk of outliving one's assets. Furthermore, whatever the initial rules for the accounts, there is likely to be considerable pressure over time for liberalizing pre-retirement access to the funds -- which is precisely what has occurred with 401(k)s and IRAs, along with the Thrift Savings Plan. Such access may make sense in the upper tier of retirement income, but not within the core tier because it undermines the preservation of funds for retirement.

- **Failing to dedicate additional revenue to Social Security means that larger benefit cuts would be necessary to restore solvency. For example, dedicating the revenue from a reformed estate tax to Social Security could eliminate the need for more than \$1 trillion in benefit reductions over the next 75 years. Every dollar of estate tax revenue dedicated to Social Security is a dollar less of benefit reductions or payroll tax increases necessary to address Social Security's projected deficit.** Despite the claims of some advocates, the Administration's proposal for individual accounts makes brutally clear that such accounts do not directly help to restore solvency. Since accounts do not directly improve solvency and may well impair it, the only available policy options to restore solvency are reductions in benefits or increases in dedicated revenue. A fundamental tradeoff thus exists: Proposals that fail to dedicate additional revenue to Social Security will necessarily involve larger benefit reductions than plans that do dedicate additional revenue to the program. When push comes to shove, Americans seem to prefer relying on additional revenue -- or some combination of additional revenue and benefit reductions -- to mainly relying on benefit reductions.

As just one example of the tradeoffs, taking the revenue from a reformed version of the estate tax and dedicating it to Social Security could close a substantial share of the projected deficit. For example, the revenue from an estate tax with a \$3.5 million exemption per person (\$7 million per couple) and a 45 percent tax rate on estates above that exemption would eliminate at least one-quarter of the projected 75-year deficit. That would obviate the need for more than \$1 trillion in benefit reductions over the next 75 years. For a 20-year-old medium-earning worker today, it could mean avoiding \$1,500 per year in benefit reductions. As a further illustration of the tradeoffs, retaining the same exemption level but reducing the tax rate on large estates to 15 percent would avoid only about \$300 billion in benefit reductions over the next 75 years. In other words, with the revenue from a reformed estate tax dedicated to Social Security, reducing the tax rate to 15 percent would increase the benefit reductions required to address Social Security's deficit by \$700 billion over the next 75 years. We as a society must decide whether this \$700 billion is better used to provide larger after-tax inheritances to wealthy children or to reduce any benefit reductions necessary to restore solvency to Social Security. Every dollar of estate tax revenue dedicated to Social Security is a dollar less of benefit reductions or payroll tax increases necessary to eliminate Social Security's deficit.

- **Recent “progressive price indexing” proposals are seriously flawed because they rely excessively on benefit reductions, cut benefits *more* if future productivity growth turns out to be faster than currently expected, and treat workers earning \$900,000 or even \$9 million a year the same as those earning \$90,000.** The recent “progressive price indexing” proposal involves surprisingly and excessively large benefit reductions for average workers. In addition, it reduces benefits *more* if productivity growth turns out to be higher than we currently expect, exactly the opposite of the appropriate response because the underlying 75-year actuarial deficit would be *smaller* with faster productivity growth. As the Congressional Research Service recently noted, “somewhat paradoxically, if real wages rise *faster* than projected, price indexing would result in *deeper* benefit cuts, even as Social Security’s unfunded 75-year liability would be shrinking.”³ Finally, the proposal treats someone earning \$900,000 or even \$9 million the same as someone earning \$90,000; a sound reform plan would instead differentiate between the two. To be sure, imposing proportionately larger reductions in monthly benefits on higher earners compared to lower earners is sensible, in part because higher earners are increasingly living longer than others. “Progressive price indexing,” however, is not the right way to accomplish that goal: It would make far more sense simply to adjust the current benefit formula directly to achieve the desired degree of protection for lower earners.

The rest of my testimony examines these points in more detail.

I. Improving 401(k)s and IRAs

The trend over the past two decades away from traditional, employer-managed plans and toward saving arrangements directed and managed largely by employees themselves, such as 401(k)s and Individual Retirement Accounts (IRAs), is in many ways a good thing. Workers enjoy more freedom of choice and more control over their own retirement planning. But for too many households, the 401(k) and IRA revolution has fallen short.

To address the problems with 401(k)s and IRAs, policy-makers and corporate leaders should make saving for retirement easier and increase the incentives for households to save for retirement. Let me give four specific examples of how this can be done.⁴

³ Patrick Purcell, “‘Progressive Price Indexing’ of Social Security benefits,” Congressional Research Service, April 22, 2005.

⁴ For further information on these and other commonsense reforms to bolster retirement security, see www.retirementsecurityproject.org.

A. Automating the 401(k)

A 401(k)-type plan typically leaves it up to the employee to choose whether to participate, how much to contribute, which of the investment vehicles offered by the employer to select, and when to pull the funds out of the plan and in what form. Workers are thus confronted with a series of financial decisions, each of which involves risk and a certain degree of financial expertise. Many workers shy away from these decisions and simply do not choose. Those who do choose often make poor choices.

To improve the design of the 401(k), we should recognize the power of inertia in human behavior and enlist it to promote rather than hinder saving.⁵ Under an automatic 401(k), each of the key events in the process would be programmed to make contributing and investing easier and more effective.

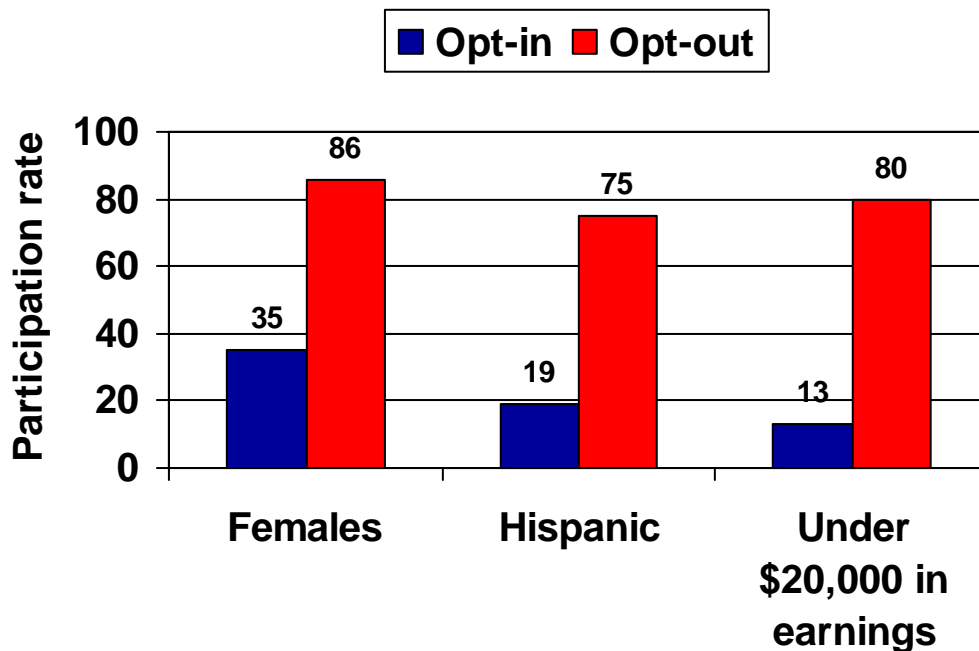
- Automatic enrollment: Employees who fail to sign up for the plan -- whether because of simple inertia or procrastination, or perhaps because they are not sufficiently well organized or are daunted by the choices confronting them -- would become participants automatically, although they would preserve the option of declining to participate.
- Automatic escalation: Employee contributions would automatically increase in a prescribed manner over time, for example raising the contribution rate as a share of earnings whenever a worker experiences a pay increase, again with an option of declining to increase contributions in this fashion.
- Automatic investment: Funds would be automatically invested in balanced, prudently diversified, low-cost vehicles, whether broad index funds or professionally managed funds, unless the employee makes other choices. Such a strategy would improve asset allocation and investment choices while protecting employers from potential fiduciary liabilities associated with these default choices.
- Automatic rollover: When an employee switches jobs, the funds in his or her account would be automatically rolled over into an IRA, 401(k) or other plan offered by the new employer. At present, many employees receive their accumulated balances as a cash payment upon leaving an employer, and many of them spend part or all of it. Automatic rollovers would reduce such leakage from the tax-preferred retirement saving system. At this stage, too, the employee would retain the right to override the default option and place the funds elsewhere or take the cash payment.

⁵ William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," Retirement Security Project Policy Brief No. 2005-1, March 2005.

In each case – automatic enrollment, escalation, investment, and rollover – workers can always choose to override the defaults and opt out of the automatic design. Automatic retirement plans thus do not dictate choices any more than does the current set of default options, which exclude workers from the plan unless they opt to participate. Instead, automatic retirement plans merely point workers in a pro-saving direction when they decline to make explicit choices of their own.

These steps have been shown to be remarkably effective, as research by Richard Thaler and others has demonstrated. For example, one of the strongest empirical findings from behavioral economics is that automatic enrollment boosts the rate of plan participation substantially (Figure 2).⁶ As the figure shows, automatic enrollment is particularly effective in boosting participation among those who often face the most difficulty in saving.

Figure 2: Effects of automatic enrollment on participation rates



Source: Madrian and Shea

Despite its demonstrated effectiveness in boosting participation, automatic enrollment is relatively new – and a small but growing share of 401(k) plans today include this feature. According to a recent survey, about one-tenth of 401(k) plans (and one-quarter of plans with at least 5,000 participants) have switched from the traditional “opt-in” to an “opt-out” arrangement.⁷ Since automatic enrollment is a recent

⁶ Brigitte Madrian and Dennis Shea, “The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior,” *Quarterly Journal of Economics* 116, no. 4 (November 2001): 1149-87; and James Choi and others, “Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance,” in *Tax Policy and the Economy*, Vol. 16, edited by James Poterba (MIT Press, 2002), pp. 67-113.

⁷ Profit Sharing/401(k) Council of America, 47th Annual Survey of Profit Sharing and 401(k) Plans (2004).

development, it may become more widely adopted over time even with no further policy changes. But policymakers could accelerate its adoption through several measures. Some of these policy measures would be appropriate only if automatic enrollment were adopted in conjunction with other features of the automatic 401(k), especially automatic escalation:

- First, the laws governing automatic enrollment could be better clarified. In some states, some employers see their state labor laws as potentially restricting their ability to adopt automatic enrollment. Although many experts believe that federal pension law preempts such state laws as they relate to 401(k) plans, additional federal legislation to explicitly confirm that employers in all states may adopt this option would be helpful.
- Second, some plan administrators have expressed the concern that some new, automatically enrolled participants might demand a refund of their contributions, claiming that they never read or did not understand the automatic enrollment notice. This could prove costly, because restrictions on 401(k) withdrawals typically require demonstration of financial hardship, and even then the withdrawals are normally subject to a 10 percent early withdrawal tax. One solution would be to pass legislation permitting a short “unwind” period in which an employee’s automatic enrollment could be reversed without paying the normal early withdrawal tax.
- Third, Congress could give plan sponsors a measure of protection from fiduciary liability for sensibly designed, low-cost default investments. If workers are automatically enrolled, their contributions have to be invested in something – and some firms are worried about fiduciary liability for these default investments. A targeted exemption from fiduciary responsibility given a prudent default would provide meaningful protection under the Employee Retirement Income Security Act of 1974 (ERISA), thus encouraging more employers to consider automatic enrollment. Defining a range of prudent defaults would enhance this safe harbor.
- Fourth, Congress could establish the federal government as a standard-setter in this arena by incorporating automatic enrollment into the Thrift Savings Plan, the defined contribution retirement saving plan covering federal employees. The Thrift Savings Plan already has a high participation rate, but if automatic enrollment increased participation by even a few percentage points, that would draw in tens of thousands of eligible employees who are not currently contributing. The Thrift Savings Plan’s adoption of automatic enrollment, along with other elements of the automatic 401(k), would also serve as an example and model for other employers.

In sum, a growing body of evidence suggests that the judicious use of default arrangements -- arrangements that apply when employees do not make an explicit choice

on their own -- holds substantial promise for expanding retirement saving. Retooling America's voluntary, tax-subsidized 401(k) plans to make sound saving and investment decisions more automatic, while protecting freedom of choice for those participating, would require only a relatively modest set of policy changes—and the steps taken thus far are already producing good results. Expanding these efforts will make it easier for millions of American workers to save, thereby promising greater retirement security.

B. Allowing part of a tax refund to be deposited into an IRA

Most American households receive an income tax refund every year. For many, the refund is the largest single payment they can expect to receive all year. Accordingly, the more than \$200 billion issued annually in individual income tax refunds presents a unique opportunity to increase personal saving.

Currently, taxpayers may instruct the Internal Revenue Service to deposit their refund in a designated account at a financial institution. The direct deposit, however, can be made to only one account. This all-or-nothing approach discourages many households from saving any of their refund. Allowing taxpayers to split their refund so that *part* of the refund could be directly deposited into an IRA could make saving simpler and, thus, more likely. The Administration has supported split refunds in each of its last two budget documents, but the necessary administrative changes have been delayed. More aggressive implementation is needed.

C. Strengthening the Saver's Credit

The vast majority of our current tax preferences for saving are problematic in two important respects. First, they reflect a mismatch between subsidy and need. The tax preferences provide the smallest benefits to lower-income families, and thus provide minimal incentives to those households who most need to save for basic needs in retirement. Instead the tax preferences give the strongest incentives to higher-income households, who are the least likely to need additional saving to achieve an adequate living standard in retirement.

Second, as a strategy for promoting national saving, the subsidies are poorly targeted. Higher-income households are disproportionately likely to respond to the incentives by shifting existing assets from taxable to tax-preferred accounts. To the extent such shifting occurs, the net result is that the pensions serve as a tax shelter, rather than as a vehicle to increase saving. In contrast, moderate- and lower-income households, if they participate in pensions, are most likely to use the accounts to raise net saving.⁸

⁸ See, for example, Eric M. Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," Working Paper 8032 (Cambridge, Mass.: National Bureau of Economic Research, December 2000), and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Economics* 87, no. 5-6 (2003): 1259-90.

The Saver's Credit, enacted in 2001, was expressly designed to address these problems. It is the first and so far only major federal legislation directly targeted toward promoting tax-qualified retirement saving for moderate- and lower-income workers, thereby helping to level the playing field of saving tax incentives. IRS data indicate that about 5 million tax filers claimed the Saver's Credit in 2002 and 2003. Despite the credit's promise, several steps are necessary to ensure that it fulfills its potential:

- First, in order to reduce the apparent revenue cost, Congress stipulated that the Saver's Credit would sunset at the end of 2006. It should be extended, which would cost between \$1 billion and \$2 billion a year. This cost should and could be offset in various ways.
- Second, tens of millions of moderate-income workers are unable to benefit from the credit because it is nonrefundable. Extending the intended saving incentive to most lower-income working families would require making the Saver's Credit refundable in some manner, perhaps directly into a retirement saving account.
- Third, another set of possible expansions to the Saver's Credit would extend eligibility to additional middle-income households. The credit could be expanded in this way along three dimensions: changes to the credit rate, the income limit, and the manner in which the credit is phased out.

In the context of evaluating ways of strengthening the Saver's Credit, it is worth noting that a research team (of which I am part) has just finished a path-breaking experiment with H&R Block exploring the effect of match rates on IRA saving. The project, undertaken under the auspices of the Retirement Security Project supported by the Pew Charitable Trusts, represents the first large-scale randomized experiment of how varying match rates affect retirement saving. The results should be ready soon.

D. Reducing the implicit taxes on retirement saving imposed by asset tests

The asset rules in means-tested benefit programs penalize any moderate- and low-income families who do save for retirement, by disqualifying them from the means-tested benefit program. The asset tests thus represent a substantial implicit tax on retirement saving.

The major means-tested benefit programs, including food stamps, cash welfare assistance, and Medicaid either require or allow states to apply asset tests when determining eligibility. Similarly, the Supplemental Security Income applies such an asset test. The asset tests may force households that rely on these benefits—or might rely on them in the future -- to deplete retirement saving before qualifying for benefits, even when doing so would involve a financial penalty. As a result, the asset tests not only penalize low-income savers but may also actually discourage retirement saving in the first place.

Asset tests in means-tested programs, as currently applied, thus constitute a barrier to the development of retirement saving among the low-income population. Modifying or even eliminating these asset tests, or disregarding saving in retirement accounts when applying the tests, would allow low-income families to build retirement saving without having to forgo means-tested benefits at times when their incomes are low during their working years.⁹

II. Individual accounts within Social Security

Although the individual accounts we already have on top of Social Security are crucially important and can be improved, the core tier of retirement income provided by Social Security is not the right place for a new set of accounts. Building ownership and wealth should not come at the expense of mortgaging future Social Security benefits -- which is precisely how the Administration's proposal for accounts *within* Social Security is structured. Nor should Social Security reform be associated with a significant increase in public debt, which results from the cash-flow problems created by individual accounts inside Social Security.

Accounts as loans

Under the Administration's proposal, the individual account system would involve two components: the individual account assets, which would contain a worker's deposits and the accumulated earnings on them, and a "liability account." If a worker chose to participate in the individual account system, four percentage points of payroll taxes (initially up to a limit of \$1,000, with the limit gradually eased over time) would be diverted into the account, accumulate during the worker's career, and be available to the worker upon retirement.¹⁰ Since the revenue diverted to this account would reduce the financing available to the traditional Social Security system, a "liability account" would also be created. The liability account would determine the debt owed back to Social Security at retirement because of the diverted funds.

In effect, the individual accounts proposed by the Administration represent a "Social Security line of credit." Workers drawing upon that line of credit receive payroll revenue in their individual account today, but must pay back the funds, plus interest at a 3

⁹ A forthcoming paper from the Retirement Security Project will examine these changes in more detail. Policy-makers considering introducing accounts within Social Security should also be careful to ensure that such accounts would not be counted under the asset tests included in various means-tested benefit programs.

¹⁰ The limit would increase by \$100 above wage inflation, at least through 2015. The Office of the Chief Actuary, in its memorandum on the proposal, indicated that the parameters of the system past 2015 had not been specified. It is noteworthy, however, that the White House Fact Sheet indicates that: "Under the President's plan, personal retirement accounts would start gradually. Yearly contribution limits would be raised over time, eventually permitting all workers to set aside 4 percentage points of their payroll taxes in their accounts." Given this statement, the analysis in this testimony assumes that the threshold would continue to increase more rapidly than wages until all workers could contribute 4 percent of taxable earnings. None of the qualitative conclusions are affected by this specific assumption.

percent real annual rate, at retirement. Indeed, margin investing has similar mechanisms and even similar terminology to the proposed accounts.

Upon retirement, the worker's debt to the Social Security system would be repaid by reducing his or her traditional Social Security benefits – that is, the monthly check paid to a retiree. Specifically, the monthly benefit reduction would be computed so that the present value of the reduction would equal the accumulated balance in the liability account. In other words, the reduction in monthly benefits would be just enough, in expected present value, to pay off the accumulated debt to the Social Security system. As Greg Mankiw, former Chair of the Council of Economic Advisers under President Bush, has written, “When a person signs up for a voluntary personal account, the government puts, say, \$1,000 in his or her account. In exchange, that person agrees to receive lower benefits from the traditional defined-benefit system, by an amount equal to \$1,000 in present value.”¹¹

This system is quite similar to a loan: As under a loan, the worker receives cash up-front and can invest the money. The worker pays back the borrowed funds, with interest, later. The specific form of the repayment, through a reduction in traditional Social Security benefits, does not alter the underlying nature of the transaction.

Actuarial and cash-flow effects

The 3 percent real rate is equal to the expected real interest rate on government bonds projected by the Social Security trustees in their intermediate cost assumptions. Since the interest rate on the loans is equal to the interest rate that the Social Security system is assumed to earn on its own funds, the system is held harmless on each individual loan, under the trustees' assumptions, as long as the loans are repaid in full.¹² Two crucial points are worth noting:

- First, even the Administration acknowledges that the accounts do *nothing* directly to reduce the long-term deficit in Social Security.¹³ In other words, individual

¹¹ N. Gregory Mankiw, “Personal Dispute: Why Democrats Oppose Bush,” *The New Republic*, March 21, 2005.

¹² Note that because of administrative costs, it is impossible for the worker to break even while holding government bonds *and* for the government to be held harmless on the transaction. The reason is that one party or the other must bear the administrative costs of the investment. Under the Administration's assumptions, for example, the real interest rate on government bonds is 3 percent per year. Under that assumption, the system would hold the government harmless as long as the worker reached retirement and paid back the loan (the government would be held harmless since the loan carries the same real interest rate as the projected government borrowing rate). The worker, however, would be worse off if she opted for an account and held government bonds in it. Such an account would have a *net* real yield of 2.7 percent per year (the 3 percent real return on government bonds minus the assumed 0.3 percent per year in administrative costs), leaving the worker with a net reduction in retirement income.

¹³ A senior Administration official was quoted on February 2 as saying, “So in a long-term sense, the personal accounts would have a net neutral effect on the fiscal situation of the Social Security and on the federal government.” A reporter then asked: “And am I right in assuming that in the way you describe this,

accounts are simply a non-answer to the question of how the deficit in Social Security will be addressed.

- Second, the accounts are actually likely to impose a negative effect on Social Security's solvency. The reason is simply that there are several likely situations in which the loan repayment back to Social Security (through reduced Social Security benefits) would be insufficient to offset the cost of the diverted revenue. Only if repayment is always made in full will the accounts be actuarially neutral over an infinite horizon. If repayment is incomplete in some circumstances, the accounts not only fail to reduce the Social Security deficit, they actually widen it. For example, if a worker dies before retirement without a living spouse, the amount in the individual asset account may be distributed to heirs, but the amount in the individual liability account could be extinguished. As a result, some "loans" are not paid off – and the system is thus made financially worse off.¹⁴ (A married worker who dies before retirement would leave her account, but also her debt repayment owed back to Social Security, to her surviving spouse.) It is worth noting that a recent proposal by Robert Pozen, a member of President Bush's Social Security commission in 2001, would avoid the actuarial hole created by pre-retirement deaths of non-married workers by having the government directly reclaim part or all of the account upon the death of such a worker.¹⁵

Even if the proposal were actuarially neutral over an infinite horizon, it would still generate a large cash-flow problem. Substantial revenues would be diverted from Social Security to individual accounts long before Social Security would receive the associated "debt repayments" from the liability accounts, since the "debts" would not be repaid until workers retired and their traditional Social Security benefits were reduced.

because it's a wash in terms of the net effect on Social Security from the accounts by themselves, that it would be fair to describe this as having -- the personal accounts by themselves as having no effect whatsoever on the solvency issue?" The senior Administration official replied: "That's a fair inference." Transcript of briefing as posted on Washington Post website: <http://www.washingtonpost.com/ac2/wp-dyn/A59045-2005Feb2?language=printer>.

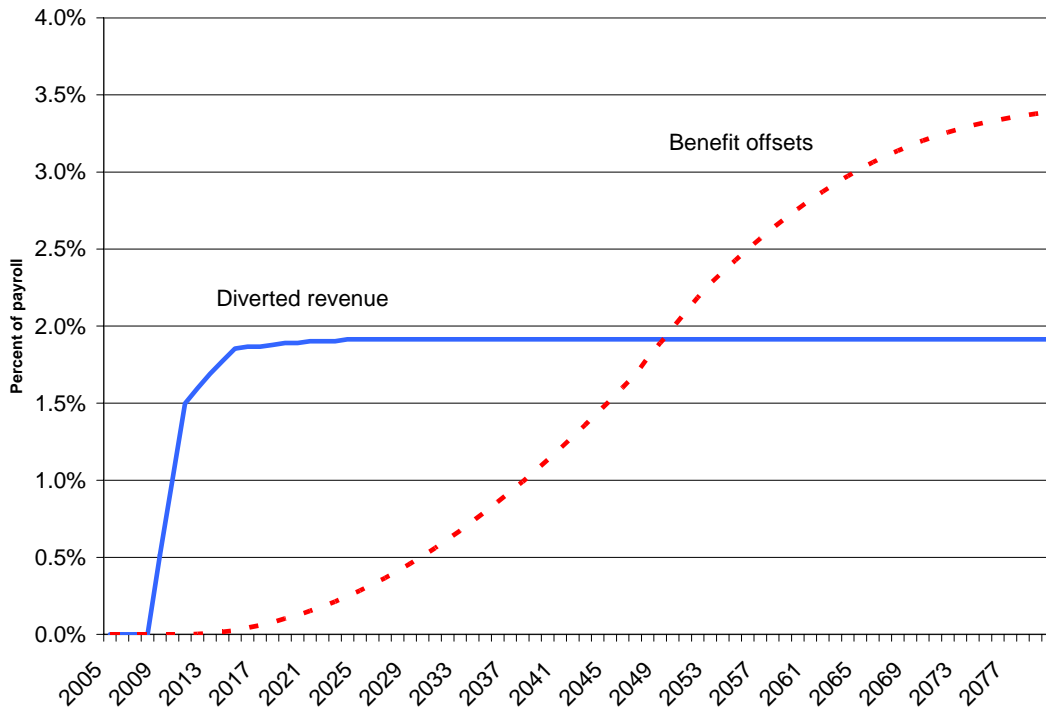
¹⁴ As another example, the benefit reductions necessary to pay back Social Security -- especially if combined with additional benefit reductions to restore long-term solvency -- may be so large that they could prove politically untenable over time. Finally, even without political pressure to reduce loan repayments, some repayments may be curtailed simply because the traditional defined benefit component of Social Security is too small to pay back the loan in full. This is particularly troubling since the progressive benefit formula implies that those with higher earnings are more likely to be in a position in which traditional benefits are insufficient to repay the loan. These effects mean that even over the problematic infinite horizon preferred by the Administration, the accounts may harm solvency.

¹⁵ As the actuarial memorandum on a plan put forward by Mr. Pozen notes, "If there are no survivors, and the worker dies before such benefit entitlement, their estate would receive the balance in their IA at death minus an offset that would be paid to the Trust Funds to compensate for their earlier allocations of a portion of their payroll taxes to their IA." See "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing, February 10, 2005—a proposal developed by Robert Pozen, member of the 2001 President's Commission to Strengthen Social Security," available at http://www.ssa.gov/OACT/solvency/RPozen_20050210.pdf.

To examine the time profile of the aggregate cash flows, I follow the Administration’s assumption that two-thirds of workers would participate in the accounts.¹⁶ Figure 3 shows the cash-flow effects. (The unusual pattern of the diverted revenue over the next few years reflects the phase-in rules for the accounts.) The cash flow from the individual accounts is negative over a period of about 45 years, because the diverted revenue exceeds the benefit offsets until about 2050.

Currently, roughly 85 cents of every dollar in non-interest Social Security revenue is used to pay benefits during the same year. If revenue were diverted into individual accounts, the reduced cash flow would drive the trust fund balance to exhaustion sooner than currently projected, requiring either some source of additional revenue to continue paying benefits or a reduction in current benefits to offset the reduced revenue flow. Indeed, the net cash outflow shown in the figure causes the trust fund to be exhausted more than a decade earlier than in the absence of the accounts – 2030 rather than 2041. Figure 4 shows the trust fund relative to Social Security’s costs each year, with and without the account proposal. As the figure shows, at each point in time, the trust fund is lower than it would have been in the absence of the accounts, because there are always some outstanding “loans” made to workers.

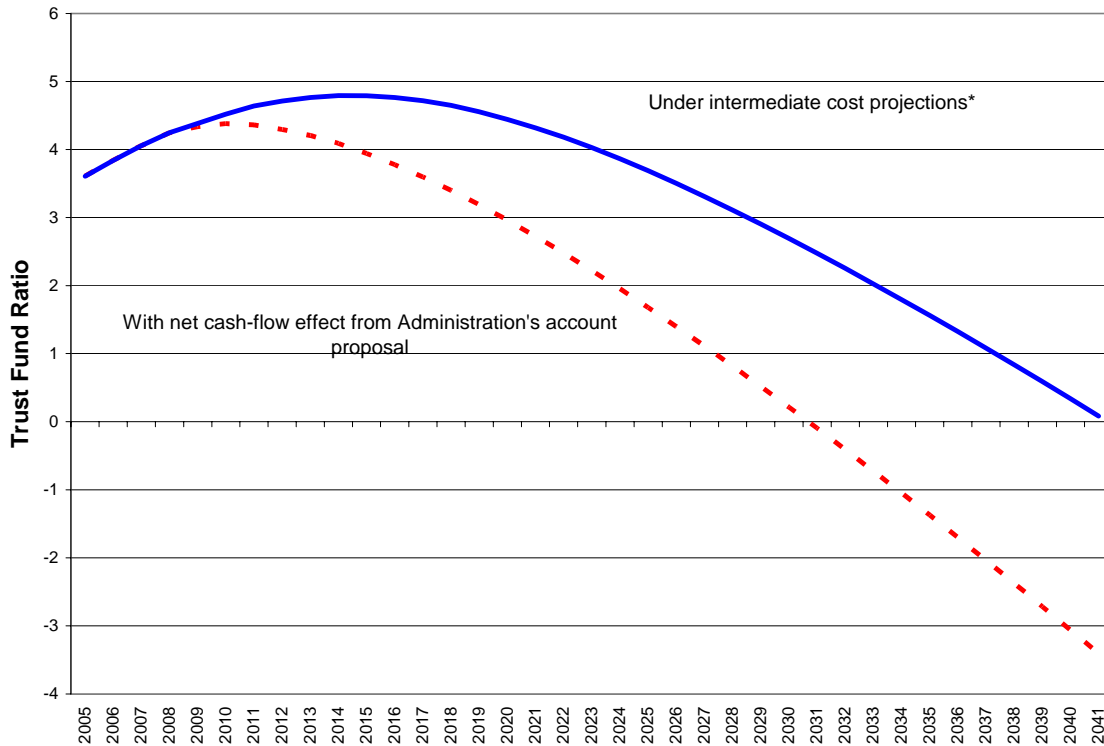
Figure 3: Cash-flow effect from Administration’s individual account plan



¹⁶ To compute the benefit offsets, I combine the figures calculated by the Office of the Chief Actuary for Model 1 from the President’s Commission to Strengthen Social Security, which assumed a 3.5 percent real interest rate for the benefit offsets, and for Model 3, which assumed a 2.5 percent rate. I thank Jason Furman for sharing some of his spreadsheets about the Administration’s plan.

Another perspective on the impact of the proposed accounts comes from the effect on the 75-year actuarial balance, the traditional measure used to evaluate solvency. While no official projection is available for the full 75-year projection period, in part because the Administration has not formally stipulated how it would handle these cash flow problems, the actuarial deficit caused by the accounts over the next 75 years would amount to about 0.6 percent of payroll. To put this in context, the actuarial deficit is currently projected to be 1.9 percent of taxable payroll; if we add the Administration's individual accounts, the deficit over the next 75 years increases to about 2.5 percent of payroll.¹⁷

Figure 4: Trust Fund ratio under Administration's individual account plan



The cash-flow problems created by the accounts manifest themselves in publicly held debt. Over the first ten years that they were in existence (2009-2018), the accounts

¹⁷ To avoid having the individual accounts accelerate the exhaustion of the trust fund, private accounts plans – including two of the plans put forward by the President's Commission – would transfer substantial amounts from the general budget to Social Security. Relying on such a transfer from the rest of budget would be a major departure from the principles that have guided Social Security for its first 70 years. To date, all of the funding has come from *dedicated* revenue sources, serving thereby to keep Social Security out of the annual budget process. This is an attractive feature for a program that should neither be changed frequently nor without adequate notice.

would raise publicly held debt by more than \$1 trillion; during their second decade (2019-2028), they would raise publicly held debt by more than \$3.5 trillion.¹⁸

The loan analogy helps to explain this increase in debt, and it also provides insight into a surprising result: The debt increase would be *permanent*. To finance a loan to a worker (provided in the form of revenue deposited into an individual account) under the Administration's proposal, the government borrows funds. If the worker repays the loan, the additional government debt on that transaction is extinguished, so public debt returns to the same level as if that worker had not opted for an account. But note that at any point in time, *even if all loans were eventually repaid*, some loans would always be outstanding. As a result, public debt would forever remain higher with the accounts than without them.

Even if the accounts were combined with proposals to eliminate the underlying deficit in Social Security, the increase in debt is likely to be extended and substantial. For example, the leading proposal from the President's Commission to Strengthen Social Security in 2001 would have changed the determination of individual benefits to incorporate what is commonly -- but somewhat misleadingly -- referred to as "price indexing." The change may sound innocuous, but as explained below, it would dramatically reduce benefits over time. For the immediate purpose, note that price indexation is sufficient by itself to more than eliminate the long-term deficit in Social Security. Yet even if the accounts proposed by the Administration were combined with this price indexing proposal, debt held by the public would remain higher than in the absence of the combined proposal for roughly five decades.¹⁹

Effects on tiers of retirement income

The cash-flow and publicly held debt problems highlighted above are not the only downsides to introducing individual accounts within Social Security. Reducing traditional Social Security benefits to make room for individual accounts would be

¹⁸ Such increases in debt would occur even if the maximum account size were capped at its (wage-adjusted) 2015 level, rather than continuing to be increased more rapidly than wages after 2015 to ensure the White House goal that all workers could eventually contribute 4 percent of payroll to the accounts.

¹⁹ Some advocates of the Administration's plan argue that the debt merely creates "explicit debt" in exchange for "implicit debt" that the government has already incurred (in the form of future Social Security benefits). From this perspective, advocates argue that the loan transactions merely trade more explicit debt for a reduction in implicit debt, since the loan repayments will reduce future Social Security benefits. The argument is then put forward that these two types of debt -- "implicit debt" and "explicit debt" -- are essentially the same, so that converting one into the other does not represent an increase in federal liabilities and should not raise concerns. This argument is, however, seriously flawed. The two types of debt are *not* equivalent. The explicit debt that the government would incur as a result of the Administration's proposal for individual accounts would have to be purchased by creditors in financial markets. When the additional debt matured, it would have to be paid off or rolled over. By contrast, the implicit debt associated with future Social Security benefit promises does *not* have to be financed in financial markets now. A government with a large explicit debt thus has less room for maneuver and is more vulnerable to a lessening of confidence on the part of the financial markets than a government with a large implicit debt. Converting implicit debt into explicit debt is thus problematic.

unsound for society as a whole because it would substantially erode the core tier of retirement income.

Figure 5 shows the tiers of retirement income under the Administration’s proposal for individual accounts if it were combined with the proposal for “progressive price indexing” that is discussed further below. As the figure shows, the core tier of retirement income provided in the form of traditional Social Security benefits would be dramatically reduced – from about 35 percent of previous wages to well under 15 percent for a medium-wage earner retiring at age 65 in 2054. Such a dramatic reduction in the foundation of retirement income raises a number of significant concerns, and the observation that the worker’s individual account could replace part of the reduced income does little to attenuate these concerns.

Figure 5: Tiers of retirement income with accounts and “progressive price indexing”

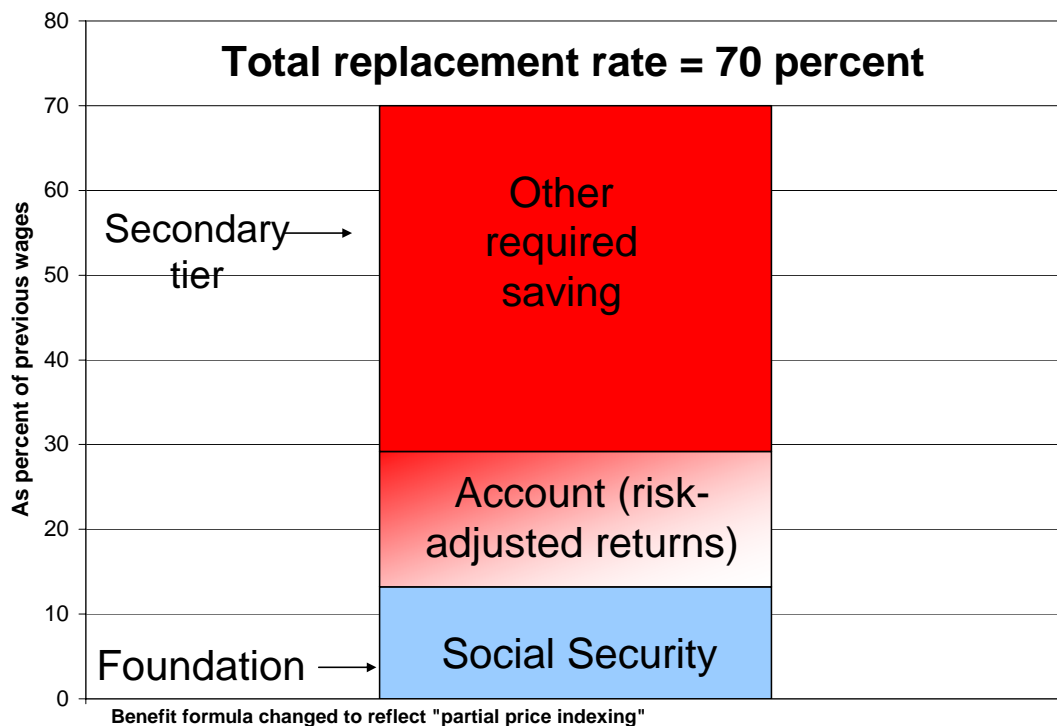


Figure shows initial replacement rates at retirement for medium-earning worker claiming benefits at age 65 in 2054

- Retirement benefits under Social Security provide an assured level of income that does not depend on what happens in financial markets. Benefits are related to the beneficiary’s average lifetime earnings and when the beneficiary chooses to retire. With an individual account, by contrast, benefits during retirement depend on the value of the assets accumulated in the account, which likewise depends in part on lifetime earnings and retirement timing, but also on how well one has invested and on how financial markets happened to perform during one’s career. It is entirely appropriate and indeed beneficial for most individuals to accept the risks of investing in financial markets as part of their overall retirement portfolio; it

does not, however, make sense to incur such risks as a way of providing for a base level of income during retirement, disability, or other times of need. *Individual accounts thus belong on top of Social Security, not instead of it.*

- Retirement benefits under Social Security are protected from inflation and last as long as the beneficiary lives. Individual accounts could, in principle, achieve similar protections by requiring account holders, upon retiring, to convert their account balances into a lifelong series of inflation-adjusted payments (that is, an inflation-indexed annuity). The Administration's proposal for individual accounts does not include such a requirement in full, however. Even if it did, any such requirement might not be politically sustainable. Individual accounts have been promoted on the grounds that they would enhance "personal wealth" and "ownership" of one's retirement assets; this seems inconsistent with maintaining substantial restrictions on how accountholders may access and use their accounts. Moreover, the goal of "bequeathable wealth," an explicit selling point of the account proposal, is in direct conflict with financing benefits that last as long as the beneficiary lives. One cannot use the same assets to both maximize benefits during one's own lifetime and leave something for one's heirs.
- The Social Security benefit formula replaces a larger share of previous earnings for lower earners than for higher earners. This provides a form of lifetime earnings insurance that is not available through private markets. For the nation, it helps reduce poverty and narrow income inequalities; for the individual, it provides security. As proposed, the individual accounts do not contribute to this form of lifetime earnings insurance.
- No political pressure exists to give earlier access to Social Security benefits. In contrast, there is likely to be considerable pressure for individual accounts to mimic 401(k)s and IRAs that allow pre-retirement access through loans and early withdrawals. Such access could undermine the preservation of funds for retirement.
- Social Security provides other benefits in addition to basic retirement income. Some of these, such as disability benefits, would be difficult to integrate into an individual accounts system.
- Individual accounts would require certain administrative costs to maintain, costs that the present structure of Social Security avoids. The higher these costs, the less generous the benefits that a given history of contributions can finance.

One final argument is worth exploring. Some advocates for accounts claim that although the accounts do not directly help to reduce the Social Security deficit, they help indirectly by serving as a "sweetener" to facilitate the necessary changes, especially among higher earners. Several points about this argument should be noted:

- The accounts are supposed to be the political deal offered to middle and higher earners, in exchange for their accepting substantial benefit reductions to restore solvency.²⁰ Again, though, the account proposal is effectively an unsubsidized loan from the government to the worker at the government bond interest rate projected by the Social Security actuaries – which, as already noted, should not be a particularly attractive offer for most higher earners.²¹ It is therefore incumbent upon proponents of the “sweetener” argument to show that the accounts do indeed serve the political purpose suggested for them (i.e., to sugar-coat benefit reductions or revenue increases).
- If the loans were subsidized, by carrying an interest rate lower than the government bond rate, they may become more attractive to higher earners. But in that case, their direct effect would *impair* long-term solvency, requiring further benefit reductions or revenue increases simply to avoid imposing harm. In this case, the net effect of the so-called “sweetener” would be beneficial to solvency only if the other changes it facilitated somehow *more* than offset its direct harm. Also note that in this case, those not participating in the accounts would, in effect, be paying the subsidies for the workers who did participate in the accounts.
- Encouraging more equity ownership and asset accumulation among moderate and lower earners is a sound policy objective, but the right approach to building ownership and assets is not by borrowing against future Social Security benefits. Instead, the types of reforms discussed in the first section of my testimony would expand ownership and asset accumulation on top of Social Security among moderate and lower earners.

In sum, the sweetener argument is typically framed as helping higher earners accept the necessary structural changes to Social Security. Yet it is unclear why such higher earners (who tend to already own a mix of stocks and bonds) should value accounts that are effectively loans at the government bond interest rate.

²⁰ For example, Robert Pozen writes: “While the Social Security benefits of most middle and high earners would still rise under progressive indexing, they would grow more slowly than under the current system. To make this package politically attractive, Congress should offer all workers the chance to offset most of this slower growth in traditional benefits by allowing them to invest two percentage points out of the 12.4% in payroll taxes they pay on all wages up to an annual maximum (\$90,000 in 2005 and rising yearly).” Robert Pozen, “The route to real pensions reform,” *The Economist*, January 6, 2005.

²¹ For workers who already own both stocks and bonds, the ability to borrow more at the government bond rate should be of little or no value: Rather than borrowing at the government bond rate and buying stocks, such workers could undertake virtually the same financial transaction at lower transaction costs simply by selling some bonds and buying some stocks. Many average and higher earners already own a mix of stocks and bonds. For example, data from the 2001 Survey of Consumer Finances indicate that 45 percent of workers earning at least \$40,000, and more than 50 percent of workers earning at least \$60,000, live in families that own both stocks and bonds (either in retirement accounts or in non-retirement accounts).

III. Solvency tradeoffs

Since individual accounts do not reduce Social Security's deficit and indeed are likely to expand it under realistic assumptions, eliminating the long-term deficit in Social Security must involve some combination of revenue increases and benefit reductions. Given this fundamental tradeoff, failing to dedicate additional revenue to Social Security increases the required benefit cuts.

When push comes to shove, Americans seem to prefer mainly relying on additional revenue -- or some combination of additional revenue and benefit reductions -- to mainly relying on benefit reductions.²² That preference is sound, since failing to dedicate additional revenue to Social Security would substantially reduce the foundation of retirement income shown in Figure 1. To maintain a solid core tier of retirement income, the solvency proposal that I designed with Professor Peter Diamond of MIT combines revenue and benefit changes, rather than relying solely on benefit reductions (as many alternative plans have done).²³ The plan does not affect benefits for workers who are 55 years old or older this year. It protects the most vulnerable beneficiaries, asks average earners to accept modest sacrifices in reform, and asks higher earners to play a somewhat larger role in reaching long-term balance. It contains no accounting gimmicks and has been scored as restoring long-term sustainable solvency to Social Security by both the Social Security actuary and the Congressional Budget Office.

Dedicating the revenue from a reformed estate tax to Social Security is an alternative way of attenuating the pressure on benefit reductions. For example, the Chief Actuary of the Social Security Administration has estimated that maintaining the estate tax at its 2009 levels -- with a \$3.5 million exemption per person and a 45 percent top rate -- and dedicating the revenue to Social Security would cover more than one-quarter of the shortfall in the Social Security Trust Fund over the next 75 years. With an exemption of \$3.5 million per person, Tax Policy Center estimates suggest that only 0.3 percent of all persons expected to die in 2011 would be taxable in 2011. Only 50 taxable estates in the entire nation would contain a small farm or small business (those valued at less than \$5 million) that comprised a majority of the estate. Yet, if the remaining deficit were closed solely on the benefit side, the revenue collected from the reformed estate tax would obviate more than \$1 trillion in benefit reductions that would otherwise be required to restore solvency over the next 75 years.²⁴ For a 20-year-old medium-earning worker today, it could mean avoiding about \$1,500 per year in benefit reductions.

²² For example, in a survey conducted by economists Alan Blinder and Alan Krueger of Princeton University, 30 percent said they would prefer to eliminate the Social Security deficit "mainly by raising the payroll tax." Another 5 percent responded "mainly by reducing Social Security benefits," while 34 percent responded "both." Alan S. Blinder and Alan B. Krueger, "What Does the Public Know about Economic Policy, and How Does It Know It?" *Brookings Papers on Economic Activity 1:2004*, pp. 327-87.

²³ Peter A. Diamond and Peter R. Orszag, *Saving Social Security: A Balanced Approach* (Brookings: 2004).

²⁴ The \$1 trillion figure is in present value, since it cumulates benefit changes over a 75-year period. The \$1,500 annual figure cited for the 20-year-old medium earner is in inflation-adjusted dollars.

If instead the tax rate on large estates were reduced to 15 percent, the revenue collected would fall dramatically. As a result, the dedicated revenue would be sufficient to close less than 10 percent of the projected 75-year deficit, and the benefit reductions obviated would amount to only \$300 billion in present value. In other words, with the revenue from an estate tax dedicated to Social Security, reducing the tax rate on large estates to 15 percent would increase the benefit reductions required to eliminate Social Security's deficit by \$700 billion over the next 75 years. We as a society must decide whether this \$700 billion is better used to provide larger after-tax inheritances to wealthy children or to reduce any benefit reductions necessary to restore solvency. Every dollar of estate tax revenue dedicated to Social Security is a dollar less of benefit reductions or payroll tax increases necessary to eliminate Social Security's deficit.

IV: The flaws in “progressive price indexing”

This final section of my testimony examines a recent proposal to adopt “progressive price indexing” for computing initial benefits at retirement. Despite its apparent popularity in some circles, the proposal is deeply flawed. It involves an excessive reliance on benefit reductions, it would cut benefits *more* if productivity growth turns out to be higher than we currently expect, and fails to ask any more of the nation's very highest earners than those with high earnings.

To understand the problems with progressive price indexing, it is first necessary to understand full “price indexing.” Although it sounds innocuous, price indexing would reduce benefits far more than appears on the surface. For example, had this rule been fully in effect by 1983, at the time of the last major reform to Social Security, benefits for newly eligible retirees and disabled workers now would be almost 20 percent lower and continuing to decline relative to current law.

Under current law, benefits for new retirees roughly keep pace with wage growth. Successive generations of retirees thus receive higher benefits because they had higher earnings -- and paid higher payroll taxes -- during their careers. This feature of the Social Security system makes sense, since a goal of Social Security is to ensure that a worker's income does not drop too precipitously when the worker retires and ceases to have earnings. A focus on how much of previous earnings are replaced by benefits (the “replacement rate”) recognizes the real-world phenomenon by which families, having become accustomed to a given level of consumption, experience difficult adjustment problems with substantial declines in income during retirement.

The price-indexing proposal would alter the current system so that in determining the initial benefit level, benefits would be reduced by the cumulative difference between wage growth and price growth from the time the proposed system were implemented to the retirement of a given generation. In other words, under “price indexing,” if average real wages were ten percent larger after ten years, the roughly ten percent benefit growth to keep pace with this wage growth would simply be removed. Since real wage growth is

positive on average, compared to currently scheduled benefits, the change would reduce initial benefit levels and the size of the reduction would increase over time.²⁵

A recent proposal, often called “progressive price indexing,” would apply “price indexing” of initial benefits for higher earners while continuing to use wage indexation for lower earners.²⁶ Specifically, the current benefit formula would continue to apply to workers in the bottom 30 percent of the wage distribution. The full price indexation proposal would be used to determine benefits for those whose wages equal or exceed the maximum taxable earnings base (\$90,000 in 2005). Workers with wages in between these two would receive some combination of the benefit under the current formula and the benefit under the price indexation formula.

The progressive price indexing proposal is seriously flawed for several reasons.²⁷ First, progressive price indexing imposes surprisingly large benefit reductions on average earners. The reason is that it attempts to close too much of the actuarial deficit on the benefit side. Other plans, such as the Diamond-Orszag one, dedicate additional revenue to Social Security, mitigating the need for benefit reductions while still achieving long-term financial balance. For example, progressive price indexing would reduce annual benefits for a medium-earner who is 25 today and retires in 2045 by 16 percent; Diamond-Orszag reduces benefits for such a worker by less than 9 percent (Table 1). The difference amounts to almost \$1,500 per year (in 2005 inflation-adjusted dollars).

Second, progressive price indexing imposes *more* substantial benefit reductions on average earners and higher earners the higher productivity growth is, even though that higher productivity reduces the 75-year actuarial imbalance in Social Security. Consider, for example, the benefit reductions for maximum earners. A medium-earning 25-year old at the time of legislation would have benefits reduced by about 15 percent under the proposal if real wage growth is 1 percent annually. The benefit reduction for the 25-year-old is significantly larger, about 25 percent, if real wage growth is 2 percent per year (Table 2), even though the 75-year Social Security shortfall would be smaller in that case. The differences are even more substantial for higher earners.

²⁵ The 2005 Trustees Report projects long-run growth of prices of 2.8 percent per year and long-run growth of taxable wages of 3.9 percent per year, resulting in a growth of real wages of 1.1 percent per year. But real wage growth may turn out to be larger or smaller than this amount.

²⁶ For further analysis of the proposal, see Jason Furman, “An Analysis of Using ‘Progressive Price Indexing’ to Set Social Security Benefits,” Center on Budget and Policy Priorities, March 21, 2005.

²⁷ The Social Security actuaries have estimated that this proposal would reduce the actuarial deficit over the next 75 years by 1.4 percent of payroll, compared to the projected deficit of 1.9 percent of payroll. In other words, more than a quarter of the gap would remain. Thus the proposal, by itself, does not restore solvency to Social Security. Furthermore, the actuarial estimates assume that progressive price indexing applies to *all* benefits – including disability and survivor benefits. If the plan were changed to conform with the widespread consensus that disability and pre-retirement death survivors benefits should be protected, its actuarial saving would be even smaller.

Table 1: Benefit reductions for workers claiming benefits at age 65 in 2045

	Progressive price indexing		Diamond-Orszag	
	Benefit (2005 dollars)	% change from current benefit formula	Benefit (2005 dollars)	% change from current benefit formula
Scaled low earner (\$16,428 in 2005)	\$12,041	0%	\$11,945	-1%
Scaled medium earner (\$36,507 in 2005)	\$16,584	-16%	\$18,052	-9%
Scaled high earner (\$58,411 in 2005)	\$19,858	-25%	\$22,935	-13%
Scaled maximum earner (\$90,000 in 2005)	\$22,829	-29%	\$25,755	-20%

Source: Calculations by Jason Furman, based on memos from the Office of the Chief Actuary

Table 2: Effect of progressive price indexing on benefits for medium earners

Age when implemented	1% real wage growth	2% real wage growth
55	0	0
45	-5%	-10%
35	-10%	-19%
25	-15%	-25%
15	-19%	-31%

Note: Calculated as $0.5647 * (.99^{55-age-1})$ and $0.5647 * (.98^{55-age-1})$ respectively. The 0.5647 factor reflects the relative percentage benefit reduction for the scaled medium earner compared to a steady maximum earner under the proposal, until the benefit formula becomes flat for the top 70 percent of workers.

Any method of automatic indexing should be designed to help keep revenues and expenditures closer to balance in the future. Progressive price indexing, though, does the reverse. Even if they are the best possible set of projections currently available, it is virtually certain that current projections of the next 75 years (let alone thereafter) will prove to be incorrect in one direction or the other. Such uncertainty is not an excuse for failing to act, but it does strongly suggest that policy changes should be adopted with an eye toward how they will perform when the future turns out to be different than we currently expect. Yet under progressive price indexing, if real wage growth is more rapid than expected, benefit cuts are *larger*. If real wage growth is more rapid, though, the underlying 75-year actuarial deficit (in the absence of this provision) is smaller. The larger actual real wage growth turns out to be, the smaller the need for benefit reductions but the larger those reductions actually are under progressive price indexing.

Third, progressive price indexing treats workers earning \$90,000 the same as workers earning \$900,000 or even \$9 million. The Diamond-Orszag proposal, along with other recent proposals, instead asks the very highest earners to bear more of the burden in restoring solvency. At the higher end of the earnings distribution, “progressive price indexing” is not actually progressive.

Finally, “progressive price indexing” ultimately leads to a flat benefit level for the top 70 percent of earners. That is, most workers within a given generation would receive the same dollar benefit even though their earnings have varied substantially (as have the payroll taxes they paid). Under the current benefit formula and under the Diamond-Orszag plan, higher earnings translate into higher benefit levels. Ultimately, progressive price indexing leads to a system in which higher earners receive the same benefit as moderate earners. The reason is that progressive price indexing reduces benefits for higher earners while not reducing them for lower earners. As a result, the benefit level for the highest earner evolves toward the level of that for the worker at the 30th percentile. Breaking the linkage between earnings and benefits in this fashion moves the system from a focus on replacement rates to one of a minimum benefit level, which in turn may undermine political support for the program. Furthermore, if the proposal were combined with individual accounts of the type the Administration has proposed, many higher earners may ultimately receive *no* check from the defined benefit component of the program because the offset associated with the accounts would more than consume their monthly benefit.

In summary, the “progressive price indexing” approach shows clearly the implications of trying to close the long-term Social Security actuarial deficit primarily by benefit reductions. Although it fails to restore solvency by itself and incorporates only one particular pattern of how benefits could be reduced for workers born in different years, it illustrates the broader implications of closing the actuarial deficit excessively on the benefit side. Not surprisingly, such an approach involves dramatic reductions relative to scheduled benefits.

It is worth emphasizing that the apparent objective behind progressive price indexing -- to attenuate the burden of restoring solvency on lower earners -- is sound. One motivation for this objective is that the extent to which people with higher earnings and more education tend to live longer than those with lower earnings and less education has increased significantly over the past several decades.²⁸ This increasing gap in life expectancy exacerbates Social Security’s financing shortfall and makes the system less progressive on a lifetime basis (since higher earners will collect benefits for an increasingly larger number of years, and thus enjoy larger lifetime benefits, relative to lower earners). For this reason along with others, it makes sense to adjust the monthly benefit formula in a manner that imposes larger proportionate reductions on higher earners than lower earners. Rather than adopting the flawed progressive price indexing

²⁸ See, for example, Jonathan Skinner and Weiping Zhou, “The Measurement and Evolution of Health Inequality: Evidence from the U.S. Medicare Population,” NBER Working Paper No. 10842, October 2004; Irma Elo and Kirsten P. Smith, “Trends in Educational Differentials in Mortality in the United States,” presented at the Annual Meeting of the Population Association of America, May 2003; and Gregory Pappas, Susan Queen, Wilbur Hadden, and Gail Fisher, “The Increasing Disparity in Mortality between Socioeconomic Groups in the United States, 1960 and 1986,” *New England Journal of Medicine*, vol. 329, no. 2 (July 8, 1993), pp. 103-09, and the correction that appeared in the October 7, 1993, issue.

approach, however, policy-makers should simply make direct adjustments to the benefit formula to accomplish this objective.

Conclusion

Individual accounts can and should be strengthened on top of Social Security, where they belong. The Administration's proposal to introduce individual accounts within Social Security would substantially increase debt, while failing to reduce the projected Social Security deficit and likely increasing it. Progressive price indexing involves unnecessarily large benefit reductions, is poorly designed in the face of significant uncertainty over future productivity growth rates, and does not ask enough of the nation's very highest earners in helping to restore solvency to Social Security. Policy-makers should instead explore ways of restoring solvency that combine revenue and benefit changes; protect the most vulnerable beneficiaries; do not involve accounting ploys or magic asterisks; and, since current projections are virtually certain to be wrong in one direction or the other, sensibly adjust to future events as they unfold.