NATIONAL AFFAIRS

Social Security and Work

Charles Blahous

In the wake of a crushing recession, with sharp declines in employment and government revenues, Social Security is much closer to going into the red than earlier projections had estimated. Last spring, the Social Security trustees reported that more than 75% of the program's previously projected near-term surplus had vanished. In September, the Congressional Budget Office offered an even more sobering prediction: Social Security will begin running deficits in 2010, and by 2019 will face annual shortfalls in the neighborhood of $60 billion, which will have to be made up out of general revenue.

These reports highlight the growing urgency of Social Security's troubles and the pressing need for change. But merely ringing the alarm bells will do little to improve the political prospects for fundamental reforms. Interest groups purporting to represent seniors are still dogmatically opposed to changing the system; the country as a whole is disinclined to do anything seen as jeopardizing benefits for the elderly; and the downsides of many of the most commonly proposed reforms are often far easier to see and explain than the long-term fiscal benefits they would bring.

Indeed, the nature of the Social Security system complicates any purely fiscal case for reform. Normally, advocates of government spending must choose between adding to the tax burden and adding to the deficit. But when future Social Security benefits are promised well in excess of projected revenues, the cost does not show up in measures of today's deficit. Instead of adding immediately to the tax burden, policymakers add to the burden of the *next* generation, a practice that permits them to duck

---

Charles Blahous is a senior fellow at the Hudson Institute. He is currently completing a book on Social Security reform entitled Social Security: The Unfinished Work. *In October, he was nominated by President Obama to serve on the Board of Trustees of the Social Security Trust Funds.*

near-term responsibility for raising taxes while blurring the long-term budget realities by quibbling over projections. And as with other entitlement programs, cost increases in Social Security occur on autopilot, so that by default the program stays on a course of ever-rising costs — however unsustainable it may be in the long run. Reforms cannot be made without new legislation that could easily be painted as either raising taxes or cutting benefits. The status quo is well entrenched.

Reformers are badly in need of a different way of thinking about fixing Social Security. Rather than treat the program purely as a fiscal problem for government, and so leave themselves open to the charge of opposing its objectives, they should advance their own values-based vision. They should put themselves squarely on the side of the broadly shared American principles of respecting and rewarding work.

In a number of largely unintentional ways, Social Security now discourages seniors from continuing to work. A set of reforms aimed at correcting these distortions would significantly improve the system's finances while also conveying solidarity with seniors who extend their working careers — either by choice or, because of the financial crisis, out of necessity. At a time when the political landscape makes a more fundamental redesign of the program highly unlikely, correcting the distorted relationship between Social Security and work offers a promising avenue for easing the program's woes.

An Aging Entitlement

When President Franklin Roosevelt and the Congress first established Social Security in 1935 as one of several federal responses to the Great Depression, the age of benefit eligibility (65 years) was set to be higher than the life expectancy of the typical American male at birth (61 years at the time). Today, however, Americans are living longer than ever before, while claiming benefits even earlier — meaning the typical beneficiary now collects Social Security for more than 18 years. Meanwhile, the vast Baby Boomer generation is starting to drift onto the retirement rolls, after having produced too few children to adequately fund the benefits they are told they will receive.

The result has been a dramatic shift in the balance between beneficiaries and taxpaying workers. In 1960, there were five workers for each beneficiary. Today that ratio hovers just above 3-to-1. As the Baby Boomers exit the work force, it will plunge rapidly to 2-to-1 within a generation.

This massive demographic change threatens to unleash unprecedented tax burdens upon younger generations. Put simply, when there are fewer workers to support each beneficiary, each worker must pay more. In 2008, the cost of paying Social Security benefits absorbed roughly 12 cents out of every taxable dollar workers earned. Without fundamental change, this toll will rise nearly 40%—to more than 17 cents of every taxable dollar—in a generation. For perspective, consider that the $700 billion cost of the TARP program (the federal government's huge, unprecedented intervention to stabilize the financial markets) amounts to less than *half* of what our children would pay in taxes to cover just a *single year* of Social Security benefit payments 25 years from now.

Add in the similar aggregate cost growth in Medicare, and our children will be paying fully one-third of their wages to support just two federal programs. This one-third levy would be taken from their earnings before funding all of the other things that federal, state, and local governments tax them to accomplish—whether providing for the national defense, paving the highways, or funding their own children's education. If we do nothing to avert this outcome, we will bequeath to our children a lower after-tax standard of living than our own.

The financial crisis and the ensuing economic downturn have only made matters worse by reducing Social Security's payroll-tax revenue and prompting an uptick in disability-benefit claims just as the program last year paid out its largest cost-of-living adjustment in 27 years.

As a result, the Social Security shortfall—long derided by defenders of the status quo as a "phony crisis"—is now rushing at us faster than either Social Security's trustees or the CBO previously predicted. Even the Obama administration's budget numbers demonstrate that government finances are on an unsustainable course unless Social Security, along with other federal entitlements, is reformed.

And the longer we wait to deal with Social Security, the more we increase the proportion of the eventual solution that will necessarily take the form of higher taxes. This is largely due to the overwhelming consensus that we should not cut benefits for those already in, or even near, retirement. We simply won't pay someone a $2,000 benefit in January and cut it to $1,600 in February. As a result, we lock in higher tax burdens with each passing year.

The cost of falling into this trap is formidable. According to the 2009 report of the Social Security trustees, current participants in the Social Security system are scheduled to receive $18.7 trillion *more* in future benefits than they will pay in future taxes. Another year's delay, as more and more Baby Boomers retire, further increases the proportion of this figure that becomes untouchable in political negotiation. To make matters worse, the sacrosanct benefits of each new class of retirees raise the bar for the minimum politically acceptable level of benefits for those who follow. It is unlikely that even the most fiscally conservative members of Congress will countenance Social Security benefit declines relative to inflation.

As a result, the window for avoiding substantial tax increases is closing fast. For those committed to a wage-indexed benefit formula, it has indeed already closed. But even for those willing to limit the growth of workers' benefits to inflation, the window for avoiding a tax increase is likely to slam shut within the decade. Every year we creep closer to insolvency, the amount of the shortfall that will have to be made up by taxes creeps up as well, regardless of which party wins the intervening elections. To bring Social Security into the black at the point of insolvency in 2037 would require a benefit cut in that year of 24%. This assumes, moreover, that we are willing to allow those already in retirement to suffer benefit cuts. Assuming instead that previous retirees' benefits will be protected, nearly all benefits for new retirees in 2037 would need to be wiped out to keep the system whole without a tax increase. This obviously will not happen. If we want to fix Social Security without imposing enormous tax increases on our children, time is of the essence.

MYTHS AND REALITIES OF PERSONAL ACCOUNTS

The most widely debated reform proposal of recent years has been the establishment of personal accounts. In 2005, President George W. Bush proposed progressive indexing of the Social Security benefit formula as a means of addressing the fiscal shortfall, and voluntary personal accounts to improve the program's treatment of younger workers. But the Congress failed to vote on this proposal—or on any other that would have improved the program's long-term outlook.

Many conservatives continue to believe that by failing to enact personal accounts when Republicans held a majority, they missed an opportunity to cure Social Security's fiscal troubles. But while personal accounts would have been a change for the better, they were not a panacea, and would have dealt with only one aspect of the system's woes. They could provide an effective means of funding future benefits, but not a pain-free way to fully close the gap between projected revenues and costs. Even if personal accounts succeeded in saving a portion of future Social Security payroll taxes, there remained a large gap between the amount of those taxes and the cost of promised benefits.

More recently, the combination of stock-market turbulence and federal deficits approaching $2 trillion has strained budgetary resources—as well as the public's appetite—for establishing personal accounts. It is worth noting that this loss of appetite has more to do with perception and spin than with the reality of proposed personal accounts. Personal-account opponents have groundlessly claimed that the stock-market decline would have devastated beneficiaries if the Bush administration had enacted such accounts in 2005. In reality, under President Bush's proposal, not a single person now receiving Social Security benefits would have held a personal account. Last year would have been the first in which accounts would even have accepted contributions from current workers. Young workers starting their investments would now have been buying in a down market. And going forward, the total proportion of a typical worker's Social Security benefit subject to investment risk would have been less than 1.5% for each year of account participation. (The precise percentage would have been higher for higher-wage workers, lower for lower-wage workers.)

Though few yet appreciate it, the market plunge could actually prove a long-term blessing for the cause of personal accounts (albeit, paraphrasing Winston Churchill, a very well-disguised one). If nothing else, the downturn has successfully smashed the idea that the case for accounts should be premised on stock-return projections. There has always been a tradeoff between higher returns and higher risk; the former could never be promised without the latter. To the extent that the case for personal accounts can be liberated from the siren song of ever-rising stock returns, it will be much stronger.

The true advantage of the personal-accounts approach is that it is far fairer to the young than continuing indefinitely with pay-as-you-go financing. As the worker-to-beneficiary ratio drops, each succeeding generation in a pay-as-you-go system is treated worse than the one before it. Personal accounts offer a way around this dilemma, allowing today's workers to save in advance for a future in which fewer workers will be around to fund their retirement. No one in his right mind would say, "The stock market is collapsing. I had better not save for retirement." But that is exactly the sort of myopia we will perpetuate if we continue to finance Social Security solely on a pay-as-you-go basis.

The other major criticism of personal-account proposals — their supposed expense — looks positively quaint now. Consider, for example, the 2005 debate over the allegedly enormous "transition cost" of personal accounts. President Bush's proposal aimed to have roughly $675 billion invested in personal accounts over the program's first ten years (CBO predicted the amount would be closer to $300 billion). This amount has already been exceeded by President Obama's stimulus package ($787 billion) and by the TARP rescue ($700 billion to date). It would also be far surpassed by the Obama administration's proposed health-care overhaul. These dollar-figure comparisons, moreover, obscure an important distinction: Each of these other three initiatives represents a *new* commitment of federal tax dollars, while the personal-account proposal would have funded *existing* commitments of Social Security.

Indeed, the Obama administration's own support for a universal auto-IRA account — which would have employers automatically send a portion of each paycheck into a retirement savings account for workers who so choose — implicitly acknowledges the prudence of long-term saving in accounts under individual ownership and direction.

The case for personal accounts, provided it includes a healthy grasp of their limits, remains strong and well grounded. But being right doesn't make the politics of Social Security reform generally, or of personal accounts specifically, any easier today. In a time of Democratic dominance of Washington, personal accounts funded by Social Security payroll taxes will not see the light of day. Meanwhile, the task of repairing Social Security's finances continues to grow more urgent. Reformers on both sides of the aisle are thus in dire need of new and viable ideas for Social Security reform — ideas that are fiscally responsible, and yet will resonate with a wide swath of the body politic.

keeping score

The first idea serious reformers should promote is an essential prerequisite for a more honest debate about the condition of Social Security: transparent, objective accounting. Perhaps the most important thing that reformers need to understand in any future Social Security negotiation is how the policy result — and especially the balance between cost restraints and new taxes — will be driven by the program's unique scorekeeping.

Reformers must avoid a negotiation predicated solely upon the concept of a "75-year actuarial balance" — at least as the balance has been calculated since a 1988 change in actuarial methods. This metric heavily tilts the playing field in the direction of tax increases in a number of ways.

First, it simply ignores any and all tax increases required to pay off the Social Security Trust Fund—as though it were money that has all been saved, rather than a debt that future taxpayers must yet redeem. Recall that it cost 12 cents out of every dollar earned by workers to pay for Social Security benefits in 2008, and that by 2036, this cost will rise to 17 cents of every dollar. As a result of the Trust Fund's legal claim on government funds, this gap between payroll-tax collections and the cost of paying benefits must be made up by raising additional general revenues (read: income taxes). The 75-year actuarial balance method simply assumes at the starting point that taxpayers will provide this substantial additional revenue.

Second, the metric counts the tax revenues raised from many workers' wages but not the benefits they will be paid. To see how this distorts our understanding of the program's finances, suppose that we only looked at the system over ten years. If we did so, we'd see the taxes paid by a 25-year-old worker, but not the benefits he will receive when he retires 40 years from now. Thus, a ten-year actuarial window would credit us with savings if we raised his taxes, but not if we constrained his benefits. The same problem exists regardless of where the time window is cut off. Whether we look at the system over ten years, or 25, or 75, by counting millions of workers' taxes but not their benefits, the metric finds that much more will be readily achieved by concentrating on the tax side.

Third, the metric makes future shortfalls appear to be smaller than they really are. This is because the scorekeeping was changed in 1988 to discount future shortfalls more heavily—employing a discount rate equal to the rate of interest presumed to be "earned" on the Social Security Trust Fund. The interest is assumed even if the money in the Trust Fund is not actually saved. This same assumption of earnings also greatly overstates the fiscal benefits of raising taxes now to address the shortfall.

When negotiating the 1983 reforms, policymakers used a simpler method, which recognized that benefits would be financed by taxing workers at the time that they are paid. It treated a deficit that would absorb 4% of wages in one year as being twice as large as a deficit absorbing 2% of wages in another year. The post-1988 discounting method, however, finds implicitly that future workers face smaller Social Security deficits, even in many instances where the tax rates threatening them are far higher.

These are among the reasons why reliance on the 75-year metric would inevitably drive negotiators to "solve" the problems of Social Security primarily by raising taxes. Raising the tax cap to cover 90% of all taxable wages, for example, would reduce the dollar amount of the outyear Social Security shortfalls by only 15%. Using this flawed metric, however, such a move would appear to solve more than 40% of the problem. If believers in limited government enter into negotiations without understanding these scorekeeping biases, they won't have a chance.

Given all this, what metrics should negotiators use? There are a number of better possibilities. One is very simple, and is a calculation that the Social Security actuary's office has performed consistently for the past decade. This metric would require that Social Security—or at least, any pay-as-you-go element within it—be returned to *annual* cash balance (or surplus) within the 75-year period, and be on a trend to stay there.

Another option would be to return to the actuarial methodology used in 1983. This method was imperfect in that it did not account for imbalances in *annual* program operations, and thus is not a complete substitute for insisting on sustainable annual cash flows. But this method would still be a useful component of improved scorekeeping, because it avoids a number of the problems cited above: It eliminates the problem of how to account for the Trust Fund, and it also values future deficits as they would actually be felt by future workers. This would do much to level the policy playing field between raising taxes and constraining costs.

VALUING WORK

Leveling this analytical playing field is an important prerequisite for reform. But to take meaningful steps in the right direction, reformers must also bring a coherent and potent policy agenda to the table. They need to make the case for changes that will lessen the pressures now driving Social Security toward insolvency, and that will send the right message about the valued place of older Americans in our society. Reformers should therefore champion ways of honoring and rewarding taxpaying work.

Experts have long understood that Social Security is effectively designed to drive seniors out of the work force. American Enterprise Institute scholar Andrew Biggs has found that the marginal return on contributions made by seniors who choose to extend their working lives is a ridiculous -49.5%. (To be clear: That's *negative* 49.5%.) This may have made sense in 1935, when the nation was trying to move seniors out of the work force to give young male workers a competitive shot at a smaller pool of jobs. But it makes no sense whatsoever given the economy, demography, and culture of our day.

Correcting these flawed incentives in Social Security will require both sticks and carrots. The carrots make for easier politics than the sticks, but reformers need to resist political pressure to simply make the system even more expensive. They should offer cost-saving measures that provide incentives to work, which would reduce the remaining shortfall that must otherwise be offset by more politically difficult fixes in the future. Reformers should trust that the American people, if fully informed, will choose rewarding work today over raising taxes tomorrow.

First, policymakers should re-evaluate the Actuarial Reduction Factor and the Delayed Retirement Credit. Under Social Security's current structure, benefits are reduced if they are claimed early, and increased if claimed late. This is done so that, if one lives an average lifetime, one's total expected Social Security benefit does not change. It also prevents individuals from gimmicking the system by manipulating the date of their benefit claims. The proportional adjustment is 20% downward if claimed three years before normal retirement age (13.33% if claimed two years before, etc.), and 8% per year upward (for up to three years) for claims made after.

This sounds reasonable at first. The problem is that individuals' work and benefit claims are correlated: People often claim benefits when they stop working, and vice versa. If they continue working and paying taxes, therefore, they often make these additional tax payments without receiving any additional benefits.

To correct this, the Actuarial Reduction Factor and Delayed Retirement Credit could both be increased to reflect, at least in part, the value of additional payroll taxes paid. One possibility is to raise the ARF from 20% to 25% for those claiming three years early and the DRC to 10% for each year after the normal retirement age. These adjustments would serve as a proxy for the expected actuarial value of the additional payroll taxes contributed by a typical senior who extends his working career. Implementing these changes would strengthen work incentives over a wide range of ages, increasing both the reward for delayed retirement and the penalty for early benefit claims.

Workers could also be offered an additional choice: the opportunity to receive the DRC as a lump sum. Few workers take the DRC now, as they are not greatly enticed by the prospect of an extra few hundred dollars per month. A lump-sum DRC, however, could well equal tens of thousands of dollars at the time of retirement—and provide a powerful motive to continue taxpaying work.

A second change worth pursuing is an improvement of Social Security's Average Indexed Monthly Earnings calculation. The current system does two things that fit together somewhat awkwardly: On one hand, it keeps track of a worker's career wage history and assigns to it an "average indexed monthly earnings" figure on which benefits will be based. On the other hand, it follows a progressive model, offering worse returns as a worker's AIME rises. As a result, for each additional year that a person works, his AIME figure climbs higher, and so his return on that year's work declines. For seniors contemplating whether to extend their working lives, the returns are especially poor.

Splitting these two functions would preserve Social Security's progressivity while also improving its work incentives. Currently, the system indexes one's past earnings history into today's terms, identifies one's top 35 earning years, and then averages them. It afterward applies the progressive benefit formula to this total. Instead, it could simply apply the current benefit formula to *each* of a worker's past earnings years. Then one's total benefit could be computed by simply adding up each of these annual benefit accruals. Instead of returns growing worse with each year of work, each worker would in effect start "fresh" with each additional work year; every new year would offer just as large a benefit reward as the year before.

This reform would reduce system costs, and would somewhat favor the steady low-wage earner over the intermittent high-wage earner. It would also enable Social Security to reward work in a manner more similar to a private-sector pension plan, in which benefits accrue with each additional year worked.

AIME reform has the added benefit of helping to repair other oddities of Social Security law. For example, the current system inaccurately perceives certain high-income workers to be low-income workers—especially immigrants (whose earnings abroad are invisible to Social Security) and state-government employees (those who spent part of their careers not participating in Social Security). As a result, it pays the generous returns intended for low earners to a subset of high earners. AIME reform would result in an appropriate return paid for each year of covered work.

Third, reformers could encourage work by eliminating Social Security's earnings test. Currently, seniors earning money between early and normal retirement age must pay a penalty of one dollar for every $2 they are paid over the earnings limit of roughly $14,000. This isn't technically a benefit reduction, but rather a benefit deferral, because the money is later returned in the form of higher monthly benefits. Nevertheless, the earnings limit sends exactly the wrong message to seniors, driving them out of the work force during the critical years between 62 and 66, when many might otherwise continue to work.

The principal effect of the earnings limit now on the books is not to prevent early benefit claims — indeed, the earliest possible age of 62 remains the most popular age of claims, despite the existence of the test — but rather to discourage paid work. This is precisely the wrong message for the government to send, and may actually have the paradoxical effect of increasing elderly poverty by inducing a too-hasty departure from the work force. Since the rationale for the current earnings test rests on the unfounded predicate of mitigating poverty among seniors, and since its adverse effects upon work are apparent, it should be an obvious target for elimination.

A fourth attractive reform is payroll-tax relief for working seniors. Many good proposals have been put forward to reduce the tax burden associated with employing seniors; these need to be thought through carefully if the government is to avoid practicing outright age discrimination. Still, two measures in particular seem worthy of consideration.

One is to exempt seniors and their employers from the disability tax. Once seniors hit the normal retirement age, they are no longer eligible for disability benefits. It seems unfair to tax them for benefits that they cannot receive. To offset the revenue lost to the disability program, the current Old Age and Survivors Insurance and Disability Insurance taxes could be adjusted.

Another promising idea is to eliminate the Social Security payroll tax entirely after 45 years of earnings, as recently proposed by Mark Warshawsky. Unlike simply eliminating the payroll tax at a given age, this approach would avoid overt age discrimination and also provide a positive work incentive on the way toward, as well as at, 45 years. It would also better avoid charges of gender discrimination: Men and women resemble each other more closely in work-force attachment than they do in life expectancy.

Another way to improve both system finances and work incentives is by capping the growth of Social Security's non-working spouse benefit.

We should not completely abandon the benefit, which recognizes the value of stay-at-home work—but there are shortcomings in its current design that can certainly stand to be improved.

To begin with, the current non-working spouse benefit produces many unnecessary and regressive transfers of income. A high-income, one-earner couple, for example, receives a higher rate of return from Social Security than a two-income, low-earner couple. The structure of the benefit is also the leading culprit in the low (-32%) incremental return on contributions to the system made by women. Moreover, the non-working spouse benefit is poorly targeted: Though intended partly to recognize the effort of raising the wage-earners of the future, it strangely provides the same entitlement whether the non-working spouse has many children, few children, or none at all.

Under today's system, a single working mother who earns half of the average wage gets a smaller benefit after a lifetime of contributions than someone who simply marries a maximum-wage earner. Capping the growth of the non-working spouse benefit so that it does not exceed benefits earned by a significant portion of the low-income working population would improve both the system's fairness and its work incentives.

Finally, work incentives cannot be fully repaired without examining Social Security's eligibility ages. Admittedly, raising the early eligibility and normal retirement ages is tougher political medicine than the other ideas discussed here. But it may be the most powerful work incentive of all: More people choose to retire at the age of earliest eligibility than at any other age. Indeed, people now tend to claim Social Security at younger ages than when the program was first established, despite the vast increases in life expectancy and personal health we have experienced since then.

The usual objection to raising the ages of eligibility is the burden it would place on laborers in physically demanding jobs. Whatever the merits of this argument (and the empirical evidence suggests they are not great), the fact remains that it was considered just fine for Social Security to provide benefits only at age 65 throughout the 1940s and '50s, when there were many more such physical laborers than today. Furthermore, the current rules allowing *everyone* to retire at 62 are a grossly inefficient way to address this perceived problem.

Moreover, raising the age of earliest eligibility is probably a useful, if somewhat paternalistic, way to address the objections to reforming the Actuarial Reduction Factor for early retirement. If the early retirement penalty is increased — however fairly from a work-reward perspective — and individuals nevertheless continue to retire at 62 despite lower benefits, there would be some increased risk of poverty among seniors who outlive their other retirement savings. By raising the age of earliest eligibility, however, reformers would implement a change that not only makes sense from a demographic standpoint, but also seems likely to help reduce elderly poverty, especially among the very oldest seniors.

PREPARING THE GROUND

By engaging the public along these lines, Social Security reformers could appeal to broadly shared American values that honor work, basic fair play, and the idea that individual choices — rather than the whims of federal policymakers — should be the principal determinants of one's prosperity. Americans will instinctively respond to the message that if they keep working and keep paying into Social Security, they should be entitled to some of the benefits of that extra work without the government taking it all away (as it now does in too many cases).

Such reforms would also speak to the difficult choices many Americans must make in the current recession. Unfortunately, all across the country, people are being pushed to extend their working lives in order to recover retirement assets lost in the financial-market meltdown. Those who remain in the work force will contribute their productivity to our economic recovery, and the system should support them as they do.

Of course, enacting these reforms will also contribute significantly to addressing Social Security's fiscal problems. The projected long-term gap between the system's annual income and costs could be reduced by as much as 40% simply by enacting the common-sense reforms described here. This would considerably reduce the difficulties faced by reformers negotiating among more politically polarizing options to finish the rest of the job.

It is time, therefore, for a new approach to Social Security: one based on honoring the labor of American workers, one that offers a way around the quicksand of today's Social Security politics, and one that charts a clear and politically plausible path to meaningful reform of the system.