A WELL-TAILORED SAFETY NET

The Only Fair and Sensible Way to Save Social Security

JED GRAHAM

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For Deborah and Max

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Preface

I ambled into the largely empty White House briefing room for the first time early one morning in December 2004 and took a seat in the fifth or sixth row, where I could observe from a distance. Just assigned to cover the White House for *Investor's Business Daily*, I was pretty excited, though a little intimidated, by the challenge ahead. But a few minutes later, I got a rude awakening. It turns out all the seats had attached nameplates and my seat was permanently reserved for the *Washington Times*. I jumped up and decided I'd be just fine standing by the door.

If you had told me what the future held on that nervous morning, I would have said you were crazy and had a good, hearty laugh. I didn't set out to try and save Social Security or challenge the status quo in Washington. My only goal was to bring some fair-minded reporting to the economic issues I'd be writing about.

The administration had declared Social Security reform its top domestic priority, and I dived in to learn everything I could. By the end of April 2005, when President George W. Bush announced his plan to erase Social Security's financing gap by slowing the growth in benefits, I had learned enough to know almost immediately that the plan would at best solve 50 percent of the shortfall. Nevertheless, the plan was attacked as "an assault on the middle class."[1]

All of Washington would soon declare Social Security reform dead, but as most members of Congress breathed a sigh of relief and my colleagues in the press moved on to the next partisan battleground, I felt that my job was unfinished. My reporting had revealed that there were legitimate reasons not to like major aspects of all the plans from across the political spectrum that had been offered and quickly cast aside, usually without any debate. But if none of these proposals made sense, what did? I felt that the issues at stake were too important to let go of without attempting to find an adequate answer to that question, and as I absorbed the best wisdom of all who have wrestled with this longstanding policy puzzle, quite unexpectedly, one idea after another occurred to me.

Four years later—an interval certainly extended by the arrival of my amazing son Max—as a new president begins wrestling with Social Security reform, I am ready to present my conclusions. Before I do, I want to express my thanks to those who helped shape my understanding of both the logic and math of Social Security reform and others who also helped make this book possible.

Eugene Steuerle's views on Social Security reform were easily the biggest influence on my own thinking. Steuerle's argument in favor of back-loading benefits to direct a greater proportion of Social Security's resources to older retirees planted the seed that would develop into a new reform provision called Old-Age Risk-Sharing at the heart of *A Well-Tailored Safety Net*.

Steuerle, a long-time Urban Institute fellow who served in the Treasury Department under President Ronald Reagan, was gracious enough to engage in an e-mail correspondence over several years and to offer many helpful suggestions as I developed my reform proposal and after reading the first draft of this book.

Ed Lorenzen, in between stints as a policy specialist for former Rep. Charlie Stenholm and Majority Leader Steny Hoyer, offered helpful analysis of my earliest efforts to draft a proposal and put me in contact with Steve Robinson, a Social Security expert for Republicans on the Senate Finance Committee, who provided critical insight as I began the intensive process of measuring the financial impact of my policy proposals.

Andrew Biggs, former deputy Social Security commissioner and now scholar at the American Enterprise Institute, provided important advice on designing payroll-tax relief for employers of older workers.

Many other Social Security policy experts whose research I came across also influenced this work, and many are cited within these pages, but here I wish to recognize those whose alternative proposals are subjected to a critical analysis in *A Well-Tailored Safety Net*. The constructive contributions to this debate from Peter Orszag, Peter Diamond, Robert Ball, Jeffrey Liebman, Maya MacGuineas, Andrew Samwick, Robert Pozen, Sen. Robert Bennett, former Congressmen Jim Kolbe and Charlie Stenholm, among others, served as essential guideposts as I sought to navigate Social Security reform with a proposal that skirted its perils and embraced its promise. I recognize that they were acting in good faith and working within political constraints to make the best of a difficult situation. While I take issue with some of their approaches, they all have at least one big upside: They would substantially reduce an unnecessary burden of debt that would be heaped on coming generations of workers if Washington continues its do-nothing approach. In certain instances, I followed their lead, adopting, for example, a more generous minimum benefit for low career earners along the lines of the Kolbe-Stenholm approach. I also adopted a scaled-down version of a proposal supported by both Bennett and Rep. Paul Ryan to end the tax-free status of employer-provided health coverage.

My work would have been impossible to complete without the extensive resources and analyses made available to the public by the Social Security Administration's Office of the Chief Actuary, ably led by Stephen Goss.

Alice Wade, deputy chief actuary, welcomed all questions and helped me understand why my present value calculations were off by two whiskers.

I'm grateful to Robert Hutchinson, my editor at Praeger, for his belief that the merit of an argument is more important than the renown of its author, and for the commitment he and the wonderful team at ABC-CLIO brought to realizing the full potential of this book. I'd also like to thank Pattie Stechschulte, project manager at BeaconPMG, who was a pleasure to work with as I made substantial revisions late in the process.

I might have been hard-pressed to publish *A Well-Tailored Safety Net* without the support of *Investor's Business Daily* publisher Bill O'Neil. He encouraged me to write a book about my ideas, even though he only had a vague notion of what I would propose but surely understood that my approach to Social Security reform would depart from *IBD*'s conservative editorial view. I also want to thank *IBD* executive editor Chris Gessel, managing editor Susan Warfel and licensing vice president Heather Davis for their support, and I want to recognize my *IBD* colleague Paul Lloyd-Strongin for generously lending his graphics wizardry to this project. The final product also benefited from the insight of *Wall Street Journal* economics editor David Wessel, who looked at an initial draft and offered advice on making the presentation more user-friendly and the tone less off-putting.

On a personal note, I'd like to thank my wife, Deborah, for having the confidence in me to say way back in 2005, "If anybody can figure it out, you can;" for putting up with wrong turns and too many late nights; and for helping push me across the finish line four years later. Thankfully, I had our beloved cat, the diva/rascal Sammy, to keep me company as I burned the midnight oil.

Lastly, I'm grateful that my grandmother Irene—still full of life at 94—and my other wonderful grandparents Bernie, Hilda and David lived long enough to demonstrate for me just how critical it is for us to maintain a robust Social Security safety net that provides comfort and dignity in very old age.

A Note on the Numbers in This Book

Numbers can be used to rig an argument. Because that isn't my intention, I want to provide a little background about the choices I made, particularly with respect to the benefit levels future retirees would receive under various proposals. Two points are in order. First, in their analyses of reform proposals, the Social Security actuaries display the percentage of benefits future retirees would receive in comparison to the current system. While that is certainly of value, an even more telling comparison is the share of benefits a worker would receive under various proposals relative to one who retired at the Normal Retirement Age and faced no early-retirement penalties. This comparison to the current law Primary Insurance Amount that is unadjusted for age of retirement—what I will refer to simply as the base benefit—reflects my belief that the appropriate benchmark is the level of income security provided by the safety net, rather than the level of income security relative to the current system that does not provide a particularly robust safety net once you subtract early-retirement penalties.

Along the same lines, in detailing the impact of various proposals, I display the level of benefits a worker would receive based on 2009 wages. This comparison reflects a different perspective than that held by the Bush administration, which promoted its approach to Social Security reform by assuring workers that most would receive a benefit more generous in inflation-adjusted terms than that received by current retirees. President George W. Bush's approach emphasized the fact that benefit levels will rise over time while downplaying the fact that workers would, over time, receive much smaller benefits relative to career income. While it is true that wage growth will raise future standards of living, arguably providing an opportunity to make Social Security's safety net somewhat less generous, I think the share of career wages replaced by Social Security is a more relevant standard than how one's benefit compares to that of current retirees.

One might reasonably argue that I was trying to rig the debate by focusing on Social Security's income-replacement rate had I offered a proposal that avoided benefit reductions. That is not the case. *A Well-Tailored Safety Net* emphasizes the importance of replacement rates for those who live to an advanced age and face a growing risk of outliving their savings, rather than for workers turning 62 or 65.

So as not to either understate or overstate the size of Social Security's financing gap, I use nominal numbers (unadjusted for inflation) with respect to Social Security projections within the 10-year budget window; inflation-adjusted numbers for program finances through 2036 and present-value numbers for the 75-year financing gap. For further perspective I provide information on Social Security's projected gap relative to the size of the economy, or Gross Domestic Product, where appropriate.

Present value reflects the level of interest-bearing deposits the government would need right now to close Social Security's financing gap. Analyses that show Social Security's actuarial deficit as $5.3 trillion in present value treat the $2.4 trillion Social Security trust fund as money in the bank. Because the trust fund doesn't provide any resources to the government, I use a figure of $7.7 trillion in present value—the total cost minus tax income found in table IV.B5 of the 2009 Trustees report. To be consistent, when stating how much of Social Security's deficit might be closed by various reforms, I use the full $7.7 trillion gap. The intent is not to strengthen the case for tax hikes relative to benefit cuts, or vice versa, but to reflect the full reality of the budget challenge related to Social Security in order to produce a more constructive political debate. While part of this challenge involves an unfunded liability from Treasury, i.e. taxpayers, to Social Security, there is no more logical time to address this trust fund debt than concurrent with Social Security reform.

Finally, I use the Social Security Administration's analysis of personal account accumulations to judge what percentage of wages a worker would have to save outside of Social Security to overcome benefit cuts. This analysis can be seen in the Office of the Chief Actuary memorandum of November 17, 2005: "Estimated Financial Effects of 'A Nonpartisan Approach to Reforming Social Security.'"

Table B1a shows how big of a lifetime annuity could be purchased by various income groups after a full career of personal account deposits equal to three percent of annual wages. Assuming investment only in Treasury bonds, the analysis shows that one percent of income saved by low earners ($18,900 in 2009) would replace 7.6 percent of their Social Security benefit, compared to 10.3 percent for an average earner ($42,000), 12.4 percent for a high earner ($67,200) and 16.8 percent for those who earn the maximum wage now covered by Social Security taxes and benefits ($106,800).

This data reflects average careers of less than 40 years for moderate wage earners. Longer careers would therefore produce better outcomes. The actuaries also assume a 0.3 percentage point annual account fee; however, if investments were limited to Treasuries, that should reduce management and transaction costs, producing slightly higher net returns.

Part I

Defining an Urgent Problem

Introduction

As the monumental house of cards built by Wall Street's financial wizards came crashing down, bringing the economy and retirement portfolios down with it, Social Security remained a relatively safe port in a raging storm, and thank goodness for that. But Social Security is only as sound and secure as the nation's finances and economy that serve as its foundation, so for the next generation of retirees, it will hardly be free of risk. The unprecedented surge of federal debt that will be a legacy of the current crisis has only advanced Social Security's inevitable day of reckoning. The levees are still holding, but the growing tide of red ink—a looming threat just a year ago—is fast becoming a clear and present danger.

The current era was supposed to be the calm before the storm—a final chance to get our fiscal house in order before the retirement of 77 million baby boomers places an overwhelming strain on the old-age safety net provided by Social Security, Medicare and, to a lesser extent, Medicaid. Instead, the economic and financial crises are projected to add several trillions in unexpected debt, raising federal borrowing and the associated interest expense to worrisome levels within a decade.

Recognizing the urgency of the problem, President Barack Obama, in an interview just before his inauguration, said that the time had come to reform these safety net programs that are collectively known as entitlements because their spending obligations have been written into law and are unconstrained by budgetary limits. "There are going to be some very difficult choices, and issues of sacrifice and responsibility and duty are going to come in, because what we have done is kicked this can down the road," Obama said. "We're now at the end of the road, and we are not in a position to kick it any further."[1]