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To: Those Interested in Social Security Reform

Date: June 21, 2002

Re.: Diamond/ Orszag study on reform plans from the President's Commission

On June 18, economists Peter Diamond of the Massachusetts Institute of Technology and Peter Orszag of the Brookings Institution released a study, entitled "Reducing Benefits and Subsidizing Individual Accounts: An Analysis of the Plans Proposed by the President's Commission to Strengthen Social Security."¹

This study generated significant attention. However, in many respects it presents a misleading picture of the choices Americans face in reforming the Social Security program and, in particular, the paths to reform put forward by the President's Commission to Strengthen Social Security. In particular, it fails to present an honest and informative comparison between the Social Security system we have and proposals intended to change and improve it.

Indeed, in testimony before the House Budget Committee June 19, Comptroller General David Walker of the General Accounting Office referred specifically to the Diamond-Orszag paper, calling its analysis "fundamentally flawed and unfair."

There's a lot of people that want to compare Social Security reform proposals just to promised benefits. That is fundamentally flawed and unfair because all of promised benefits are not funded. There is a huge shortfall between what's been promised and what's been funded, and you've got to figure out how you're going to close that shortfall. So, any analyses, *including the ones that were released yesterday*, that compare the benefit cuts based upon promised benefits solely rather than funded and promised, is unfair, unbalanced, in my opinion inappropriate. So, therefore, when GAO does work...we compare it to both funded and promised benefits. Both are relevant. One or the other is not appropriate. You need to look at both, and you need to determine how to close that gap.²

The remainder of this memo addresses issues raised by Diamond and Orszag study. To summarize, the Diamond-Orszag study:

- Compares benefits paid by Commission reform plans to those "promised" by the current Social Security program. Comparisons to the much lower benefits the underfunded program would actually pay under current law are absent.

¹ The report, co-sponsored by the Center on Budget and Policy Priorities and the Century Foundation, is available from at www.cbpp.org/6-18-02socsec.pdf. A technical version is available at <http://www.cbpp.org/6-18-02socsec-tech.pdf>.

² Testimony of David Walker, General Accounting Office, before the House Budget Committee, June 19, 2002

- Criticizes the size of the general revenue transfers proposed by Commission proposals, while downplaying the fact that general revenue transfers to maintain the current program would be over twice as large, in today's dollars.
- Attacks the Commission's proposal to "price index" the growth of future benefits, even though Diamond had strongly advocated price indexing in the past.
- Reduces the returns paid to personal account investments through "risk adjustment," even though both Diamond and Orszag have in the past supported government investment of the trust fund in equities and did not apply such risk-adjustment techniques.
- Fails to put forward a realistic alternative plan for long-term sustainability to which the Commission's proposals could be contrasted.

What is the proper baseline of comparison?

Winston Churchill was reputedly once asked "How is your wife?" to which he replied "Compared to what?"

The same answer should apply when someone asks, "How are the Social Security plans from the President's commission?": Compared to what?

What the Diamond-Orszag paper shows is that, when compared to a mythical Social Security system that can pay full benefits forever without raising taxes, the Commission's plans don't always provide higher benefits. But these comparisons, which pretend that Social Security faces no funding crisis, are useless for the purposes of analyzing the difficult choices that policymakers face.

Objective analysis, as the GAO's Walker noted above, compares a Social Security reform package to the real alternatives, not to a hypothetical world in which Social Security faces no problems.

Those real alternatives are:

- **Doing nothing**, in which case the trust fund becomes insolvent in 2041. When that occurs, by law benefits must be cut by 25 percent, which larger cuts to follow. This scenario is current law, under which Social Security will provide its "payable" level of benefits.
- **Doing something**, be it increasing revenue or generating new revenue by increasing the rate of return of system assets. If done sufficiently, these steps would enable Social Security to pay its full scheduled, or "promised," benefits through 2075 (or, hopefully, indefinitely). To pay full benefits through 2075 would require infusing some \$19.6 trillion (in today's dollars) in new revenue into the system beginning in 2041.

These alternatives produces two "baselines" to which we can compare a given reform plan:

- **Current law**, in which tax rates remain at 12.4 percent and benefits are cut by 25 percent or more in the future; and
- **“Promised benefits,”** in which taxes are ultimately increased to almost 20 percent of wages in order to pay the benefits Social Security has promised.

In other words, we can compare reform plans to a baseline in which payroll tax rates are held constant and benefits paid are less than those promised, or to a baseline in which payroll taxes are increased³ and full promised benefits are paid.

So which “baseline” do Diamond and Orszag compare the Commission’s plans to? Neither.

Instead, they compare the commission’s reform plans to a hypothetical Social Security system in which full scheduled benefits can be paid indefinitely, but without “doing something” to shore up the system’s finances.

That is to say, Diamond and Orszag compare the Commission’s reform proposals to a Social Security system that quite literally doesn’t exist. There is no such Social Security program that can pay benefits past 2041 without making changes. The Social Security system that does exist will require \$23 trillion in tax increases (in today’s dollars) to pay the benefits Diamond and Orszag tout, yet those massive tax increases are relegated to the small print of their paper.

This methodology stands in contrast to what Diamond has said in the past is the proper approach:

One should not compare a well-designed system of one kind with a poorly designed system of the other. That sort of comparison may be the stuff of polemics, but does not belong in good policy analysis.⁴

Yet this is exactly what Diamond and Orszag do: compare a well-designed – or at the very least, solvent – system with one that would require a fifty percent increase in payroll tax rates to pay the future benefits it has promised.

Diamond and Orszag’s selective use of baselines is proof of the adage that if you torture the numbers enough, they will confess. And confess they do, in Diamond and Orszag’s view, to “benefit cuts” of up to 46 percent. But when compared to what Social Security can afford to pay – that is, what the current system will actually pay if we do not raise taxes – the Commission’s personal account plans pay all workers substantially increased benefits. Many workers, particularly low-earners, would receive up to 50 percent more than they would under current law. That is a “cut” only in the cost-free world that Diamond and Orszag construct.

³ Or other tax revenues of equivalent size devoted to the program.

⁴ Peter Diamond, “Discussion of Orszag-Stiglitz paper for World Bank conference: New Ideas about Old Age Security – The transparency myth,” available at <http://econ-www.mit.edu/faculty/pdiamond/files/orszag.pdf>

An analogy: Imagine that you work for a small company and earn \$30,000 annually. Your boss promised you a raise to \$40,000, but you know from looking at the company's financial statements that it couldn't possibly pay you that much.

In the meantime, another company comes along and offers you a job at a salary of \$35,000 per year.

Question: did you receive a pay cut or a pay increase?

According to Diamond and Orszag's logic, you suffered a massive pay cut because you were promised \$40,000, even if it couldn't be paid. According to most people, however, that new job gave you a \$5,000 pay increase.

This example sums up the debate over "benefit cuts" in the President's Commission's reform plans. Diamond and Orszag castigate "cuts" relative to what Social Security promises, but cannot pay. The Commission's personal account plans produce improvements versus what Social Security pays today and versus what it can actually pay in the future. Most lower-wage workers, in addition, would receive benefits higher than those even promised by the current program.

Accurate Baselines

The accompanying table excerpted from the Diamond-Orszag paper details "benefit cuts" of up to 46 percent in the Commission's Plan 2. These frightening figures are often cited by opponents of reform without any explanation of what they signify.⁵

Line 1 shows Social Security's "scheduled" benefits – that is, the benefits Social Security's benefit formula promises to pay a worker retiring in a given year. (Of course, since Social Security is insolvent, these benefits cannot be paid once the trust fund becomes insolvent in 2041. More on that below.)

Line 2 details how much Plan 2's "price indexing" approach would reduce benefits versus those currently promised. Line 3 shows the benefit increase workers could expect by holding a personal account, while Line 4 shows the "offset" from their traditional benefits account holders accept in exchange for diverting part of their payroll taxes to the account.⁶ Line 5, the sum of Lines 2-4, shows the total monthly benefit. Lines 6 and 7 show the percentage reductions in benefits versus those currently promised.

⁵ Consider, for instance, statements by Sen. Jon Corzine (D-NJ). Analysis of these related arguments is presented in a separate memo available at www.socialsecurity.org/pubs/articles/art-biggs020523.html

⁶ To calculate benefits for non-account holders, simply ignore both lines 3 and 4.

Now, Diamond and Orszag take these figures straight from Social Security’s actuaries’ memo analyzing the Commission’s plans. However, on the very same page they obtain these

Combined Monthly Benefit Levels For Each Member of a Two-Earner Couple Claiming Benefits At Age 65 In 2075 Under Model 2			
In 2001 Dollars	Low earner (\$15,875 in 2002)	Medium earner (\$35,277 in 2002)	High earner (\$56,443 in 2002)
1. Scheduled benefits	\$1,231	\$2,032	\$2,685
2. Minus benefit reduction for all such beneficiaries	-\$425	-\$933	-\$1,233
3. Plus annuity from individual account	\$577	\$989	\$1,040
4. Minus further Social Security benefit reduction for those selecting individual accounts	-\$281	-\$473	-\$489
5. Equals total expected benefit	\$1,102	\$1,615	\$2,003
6. Percent change in benefits without the individual account (change from benefits scheduled under current law)	-35 percent	-46 percent	-46 percent
7. Percent change in benefits with the individual account (change from benefits scheduled under current law)	-10 percent	-21 percent	-25 percent
The “Missing Figures”			
8. Current law (payable) benefits	\$825	\$1,361	\$1,800
9. Percent change in total retirement benefits with the individual account	+34 percent	+19 percent	+11 percent

numbers, the actuaries provided *other* data comparing the reform plans to benefits from current law Social Security – that is, the insolvent Social Security we actually have, not some hypothetical program that can pay full benefits without raising taxes. Social Security’s actuaries saw fit to include such information. The fact that Diamond and Orszag deliberately leave this data out leads one to question their dedication to a full and informed debate.⁷

Line 8, which I have included based upon data in the actuaries’ memo, shows *the benefit that Social Security can actually pay workers retiring in 2075*. Since the program will be insolvent, this payable benefit is far lower than the “promised” benefit shown in Line 1. A low-wage worker, for instance, could expect to receive just \$825 per month under current law, versus \$1,231 that he has been

promised. Plan 2 would pay him \$1,102 monthly. *Compared to what the current system would actually pay him, this is anything but a benefit cut.*

Line 9 shows the percentage change in Plan 2 benefits versus current law payable benefits, including all benefits from the traditional program and from the personal account. For lower-wage workers in particular these constitute large increases.

⁷ Diamond and Orszag’s explanation for using only the baseline of promised benefits almost brings a smile to one’s face: “The problem with multiple baselines is that they are more likely to confuse than illuminate the debate. By using a single baseline, we assess both changes in benefit levels and the fiscal implications of the proposals relative to the same standard. This removes the temptation to use selectively one or another of multiple baselines, in order to make the proposals appear more or less attractive than comparisons to a single baseline would suggest.”

The difficulty, of course, is that the “promised benefits” baseline they utilize is almost bound to engender confusion because only the most knowledgeable readers are aware of the extent to which current law tax rates underfund the benefits their choice of baselines implies. It is precisely for this reason that Comptroller General Walker called the Diamond-Orszag baseline “fundamentally flawed and unfair.” Had they presented both benefit baselines this confusion regarding relative costs and benefits could have been reduced or avoided entirely.

A short note is merited regarding Diamond and Orszag’s treatment of benefits paid under Plan 3. While for Plan 2 the authors examine benefits paid to workers at age 65 to show large “cuts” versus promised benefits, for Plan 3 Diamond and Orszag concentrate on benefits paid at age 62. Ostensibly their reason is that Plan 3 adjusts the benefit formula to reward delayed retirement, implementing larger benefit penalties for those who retire early. Just as important, however, may be that in almost all cases retirees under Plan 3 would see no reductions in benefits versus those promised by the current program.⁸ In other words, for 65-year-olds the authors could not show the “cuts” that form such a central part of their argument. When one factors in that Plan 3 exceeds promised benefits while substantially reducing general revenue requirements, it would look even more attractive relative to the current system.

<i>The Benefits and Costs of the current Social Security program versus the Bush Commission's Plan 2</i>			
	Social Security “promised benefits”	Commission Plan 2	Current law Social Security “payable benefits”
Monthly benefit for low-wage retiree, 2075 (in \$2001)	\$1,231	\$1,102	\$825
Cost of program, as percent of payroll subject to taxation	19.4 percent of taxable wages	9 percent of taxable wages	13.3 percent of taxable wages (12.4 percent payroll tax, plus revenue from taxation of benefits)

One final point is worth making. Even if one insists on comparing the Commission plans’ benefits in 2075 to the current program’s “promised” benefits, *one should not ignore the fact that in 2075 Plan 2 would cost less than half as much as maintaining the current system. In fact, Plan 2 would cost significantly less even than current-law Social Security, which would pay a low-wage retiree benefits some 34 percent lower than Plan 2.*⁹

Why do Diamond and Orszag analyze only 2 of the 3 Commission Plans?

Diamond and Orszag analyze just Plans 2 and 3 from the Commission. Why not Plan 1? It is because, they say, Model 1 “would not restore long-term balance to Social Security and is therefore not considered further here.” In other words, you shouldn’t compare solvent plans like 2 and 3 to an insolvent proposal like Plan 1.

That’s entirely correct. But it’s also exactly what Diamond and Orszag do when they compare *solvent* reform plans like Plans 2 and 3 to the promises of an *insolvent* current system. If solvency is not a criterion – and Diamond and Orszag’s baseline implies that it’s not – then Plan 1 should be analyzed as well. Plan 1 is not fully solvent, but it is less insolvent than the current program.¹⁰ Moreover, it would pay higher total retirement benefits to all retirees than the current program.

⁸ This is true at age 65, even though these workers would be considered “early retirees” and thus subject to the increased early retirement penalty under Plan 3.

⁹ Assuming 100 percent participation in personal accounts, Plan 2’s cost rate (or required tax rate) would be 9 percent, versus 19.4 percent for the current system to pay full promised benefits. Assuming 67 percent participation, Plan 2’s cost rate would rise to 10 percent.

¹⁰ In terms of 75-year actuarial balance Plan 3 is slightly less solvent than current law; however, this is a function of the fact that the 75-year window does not count savings to the traditional program amassed during the 75

Based upon their own criteria for analysis, which pay no heed to the revenue needed to pay promised benefits, Plan 1 would be superior to the current program. But since Plan 1 incorporates voluntary personal accounts, such a comparison would be most uncomfortable for the authors. Hence, any analysis of Plan 1 is omitted.

The Commission was careful to distinguish between Plan 1 and Plans 2 and 3, for the reason that comparisons between insolvent and solvent proposals are bound to be confusing. For the very same reason, comparing the Commissions Plans 2 and 3 to an insolvent current system is misleading in the extreme.

General Revenue Transfers

Diamond and Orszag are highly critical of the transfers of general tax revenue incorporated in the Commission's reform plans. However, their critique is puzzling when their own views are taken into account.

The Commission's Plans 2 and 3 each contain transfers of general revenue to Social Security. Plan 2 incorporates transfers for a limited time to maintain system solvency during the period in which personal accounts are building value but have yet to begin paying benefits. Plan 3 contains similar "transition" transfers, as well as ongoing dedicated transfers of general revenue that would continue permanently.

Diamond and Orszag say:

Models 2 and 3 are dependent upon large, multi-trillion dollar transfers from the rest of the budget. The Commission report provides no indication, however, of where these transferred funds would come from. The failure to identify the source of the revenue transfers represents a serious gap in the financing of the plans, since budget forecasts from the Congressional Budget Office, the General Accounting Office, and other budget analysts show little or no budget surplus outside Social Security in either the short term or the long term. To the contrary, as the baby boom generation retires and health care costs continue to rise, the budget outside Social Security is projected to go substantially into deficit. This means there are no available sums to transfer without causing even larger deficits outside Social Security. The proposed transfers thus effectively constitute a large "magic asterisk" that serves to mask the adverse financial impact of the individual accounts on Social Security solvency. The assumed, unspecified general revenue transfers would be very large.

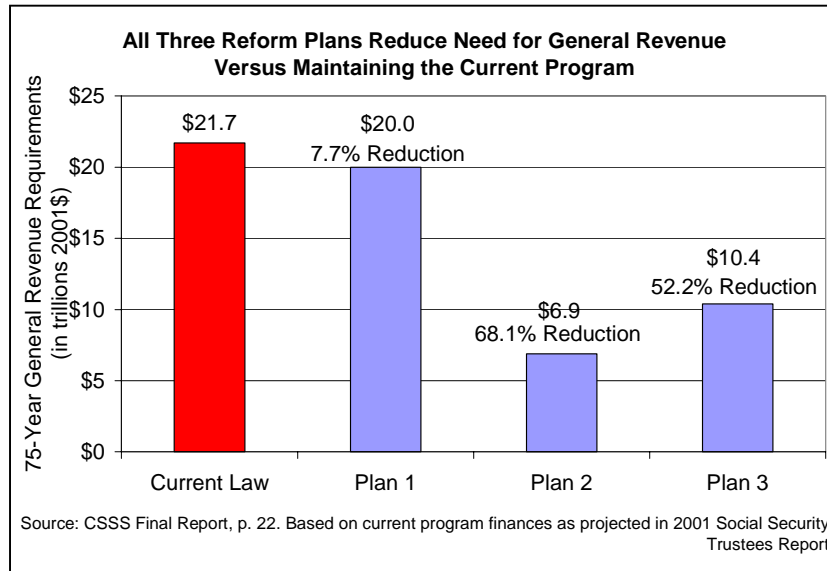
In one sense, these criticisms are clearly true: the budget is currently in deficit, the Commission did not designate specific sources of general revenue,¹¹ and pressure on the federal budget is projected to grow as the population ages.

years but "paid back" to the program afterwards. On a permanent basis, Plan 3 would be cheaper than current law while paying higher expected benefits to all retirees.

¹¹ It is worth noting, however, that designating specific sources of general revenues that would be transferred to Social Security years or decades into the future is essentially meaningless. Congress decides tax and spending policy on a yearly basis. Any Commission recommendations, even if written into law today, could be reversed (either explicitly or effectively) by Congress in any subsequent year.

Compared to Diamond and Orszag’s baseline – in which benefits magically flow regardless of whether there are taxes sufficient to support them – these revenue transfers appear a burden.

But compared to real world – and in particular, the policy proposals Orszag, Diamond and other account opponents appear to favor – the general revenue transfers needed for Plans 2 and 3 are small. Plans 2 and 3 don’t make maintaining Social Security *easy* in the face of Baby Boomer retirements and an aging population, they simply make it *easier* than the alternatives favored by account opponents.



Consider the following: To maintain full promised benefits for the next 75 years under the current program would require general revenue transfers of \$21.7 trillion (in today’s dollars).¹² This is the under-emphasized general revenue cost of the Diamond-Orszag baseline.

Under the Commission’s Plan 1, which does nothing other than introduce voluntary personal accounts, the 75-year general revenue cost would be reduced

by 7.7 percent to \$20 trillion. Under Plan 2, the size of general revenue infusions needed would fall by 68 percent to \$6.9 trillion, while for Plan 3 they would fall by 52 percent to \$10.4 trillion. In all cases, savings versus the current program would increase beyond the 75-year window.

In other words, while all three Commission proposals may be expensive, they are far *less* expensive than maintaining the current program.

These general revenue cost comparisons reveal a fundamental illogic in the Diamond-Orszag analysis. They acknowledge, to their credit, that keeping Social Security solvent will require a combination of revenue infusions and reductions in the growth of benefits. Their argument with the Commission, they say, is that Commission proposals rely too heavily on the benefit end of the equation. This view is fine, except that it is totally at odds with their belief that the Commission’s general revenue infusions are already unrealistically large. As a matter of simple mathematics, they can’t say *both* that the Commission’s benefits are too low and its general revenue infusions too high. To balance the current program under their own criteria, they would require either lower benefits than paid by the Commission or higher revenue infusions.

¹² These figures are based upon assumptions in the 2001 Social Security Trustees Report. In the 2002 report, the long-term payroll tax deficit equals \$23.9 trillion.

Diamond and Orszag also argue that had the same general revenue transfers used in Plans 2 and 3 been devoted to the current program, the current program could in fact pay higher total benefits than either of the Commission's personal account plans. For instance, they claim that using the same general revenue transfers as in Plan 2, the current program would have to cut benefits for an average 2052 retiree by only 9.9 percent, versus a 26.1 percent reduction from promised benefits under Plan 2.

But this analysis has several flaws:

First, Diamond and Orszag compare their supplemented current program only to personal account holders investing solely in government bonds, not the 50 percent stock-50 percent bond default portfolio utilized by Social Security's actuaries. Making this change would increase Plan 2's benefits to 93.7 percent of those promised, a reduction from promised benefits of 6.3 percent rather than the 26.1 percent figure cited by the authors.

Second, the authors treat the trust fund as an effective means of prefunding future benefits, such that a general revenue transfer in any given year can be effectively carried over to any other year. A central conclusion of the Commission's interim report which shaped its policy in favor of personal accounts was that the trust fund has not been effective in saving. Deposits to the fund encourage higher non-Social Security spending today and must be redeemed with higher taxes in the future.

Third, Diamond and Orszag dedicate general revenues in their alternative model to maintaining solvency over 75 years, while Plan 2 achieves solvency permanently.¹³ In other words, the benefits Diamond and Orszag show during the 75-year period would fall precipitously in the 76th year, while under Plan 2 this "cliff effect" would not take place. To make an even comparison Diamond and Orszag should apply their general revenue transfers not to reducing the 75-year actuarial deficit of 1.87 percent of payroll but the "perpetual" deficit, calculated by Social Security's actuaries at approximately 4.7 percent of payroll.¹⁴

A comparison reflecting these changes would show the Commission's alternative plans paying workers higher expected retirement benefits than the current program.

Benefit Offsets and "Liability Accounts"

In what appears to be an effort to frighten the public, Diamond and Orszag argue that workers choosing personal accounts would also be saddled with a "personal liability account," a debt to repay to Social Security, and a debt they would pass on at their death:

Since the revenue that was contributed to an individual account would be diverted from the Social Security Trust Fund, the Commission would also create a "liability account" to

¹³ Plan 3 was also scored as being solvent indefinitely due to dedicated ongoing general revenue transfer included in the proposal. Without those transfers, however, it would not achieve sustainable solvency.

¹⁴ In 1997, Steve Goss, now Chief Actuary for the Social Security Administration, estimated Social Security's actuarial balance for perpetuity (i.e., its surplus or deficit extending indefinitely) at a deficit of 4.7 percent of payroll. In conversation, Goss estimated that using assumptions contained in the *2000 Trustees Report* would produce a similar projection or perhaps slightly closer to 5 percent of payroll, though subsequent actuarial projections may have reduced this figure somewhat.

track the amounts owed back to Social Security by workers who elect to contribute to individual accounts. Upon retirement, this liability account would be “repaid” by reducing a worker’s traditional Social Security benefit.

In a technical sense, Diamond and Orszag are correct. On the whole, though, their use of the terminology of liabilities makes a straightforward benefit offset appear to be something far more sinister.

In a voluntary personal account system, it is obvious that a worker choosing to divert part of his payroll taxes to an account would accept a lower benefit from the traditional system at retirement. This traditional benefit reduction can be referred to as an “offset.”

Imagine a simple benefit offset: a worker who invests one-sixth of his payroll taxes (2 percentage points) in a personal account would accept a one-sixth reduction in his traditional Social Security benefits. Clearly, this would not produce a “liability account,” in the alarming sense used by Diamond and Orszag. However, such a straight “one-sixth for one-sixth” offset is impracticable because it can produce undesirable outcomes such as reducing the progressivity of the program and treating mid-life workers different than those at the beginning of their careers.

The Commission adopted a more flexible approach. Workers choosing personal accounts would accept offsets to their traditional benefits based upon *the amount they contribute to the account*. Older workers, workers with lower wages, or disabled workers would contribute less over their lifetimes, and therefore their traditional benefits would be reduced by less. The Commission’s benefit offset would compound account contributions at a given interest rate (3.5 percent, 2 percent and 2.5 percent for Plans 1, 2 and 3, respectively). So long as a worker’s account investments earned a return higher than the designated benefit offset rate, the worker would receive higher total benefits at retirement. Under Plans 2 and 3 workers could expect to increase their total retirement benefits without investing even a penny in stocks. A worker could invest only in guaranteed government bonds earning 3 percent annually and still receive higher total benefits.¹⁵

As a side note, the Commission’s benefit offset is not a “clawback,” as some have mistakenly stated. A clawback reduces benefits based upon the *end balance* of an account, including investment earnings, while the Commission’s offset reduces traditional benefits based upon the *contributions* to the account. A clawback undermines an individual’s ownership in his account and can influence investment choices and risk taking in undesirable ways, while the Commission’s benefit offset lets workers make their investment decisions based solely upon their own weighing of risk and returns.

“Subsidizing” Personal Accounts

Diamond and Orszag criticize the personal account benefit offset mechanism in the Commission proposals on the grounds that

Both Model 2 and Model 3 *subsidize* the individual accounts by charging an interest rate on the liability accounts (i.e., on the amounts diverted from the Trust Fund) that is

¹⁵ Social Security’s actuaries assume that corporate bonds would return 3.5 percent annually after inflation, while stocks would return 6.5 percent.

projected to be lower than the return the Trust Fund earns on its reserves. *Since the interest rate charged on the amounts diverted from the Trust Fund would be lower than the interest rate the Trust Fund would have earned on those funds if they had not been diverted, the individual accounts cause deterioration in Social Security's financial status.*

What this means, as pointed out above, is that even by investing in government bonds, workers under Plans 2 and 3 would receive higher retirement incomes than by staying in the current program.¹⁶

However, this “subsidy” should not be treated in isolation. It was financially feasible for the Commission to “subsidize” personal accounts to make them attractive to even the most risk-averse workers because they had made the traditional system financially sustainable. In precisely the same way, however, putting the traditional program solvent and sustainable made it financially feasible to provide a new anti-poverty guarantee for minimum wage workers or to increase benefits for lower-wage widows by up to 50 percent. An insolvent system could not afford to make any of these beneficial changes.

Moreover, one should not construe this subsidy to mean that funding or benefits are lost to Social Security. Imagine, for instance, that we were simply to transfer the government bonds currently in the trust fund to individual's personal accounts. A dollar lost to the fund would be a dollar gained by an account, but in either case that bond would be used to pay Social Security benefits. The only difference is that workers holding these accounts would have – for the first time – Social Security benefits backed by the full faith and credit of the United States government.

A side argument Diamond and Orszag make is that the “subsidy” to personal accounts in Plans 2 and 3 favors high-wage over low-wage workers:

A lower earner choosing to divert revenue into an account would receive a smaller subsidy than would a higher earner, so that the subsidies represent a *regressive* feature of the Commission plans.

The authors' use of the word “regressive,” however, is contrary to its use in other contexts. For instance, high-wage workers receive larger monthly Social Security benefits than low-wage workers. Does this make Social Security regressive? Of course not, because low-wage workers receive higher benefits *relative to what they contribute*.¹⁷ Likewise, under the Commission's Plan 2 a low-wage worker receives a “subsidy” *four times higher relative to his income than a maximum-wage worker*. This is hardly regressive by any standard used in common English.

To prove the point, consider the effect personal account ownership has on the total benefits for a low and a maximum-wage worker under Plan 2. For workers retiring in 2052, for instance, a personal account would increase a low-wage worker's total benefit by 48.5 percent, versus a 32 percent increase for a maximum-wage worker.

¹⁶ Under the Commission's Plan 1, the benefit offset rate is set at 3.5 percent after inflation. Since the trust fund's bonds are assumed to earn a 3 percent return, in this case the accounts effectively subsidize the traditional program. Even with this reverse subsidy, however, individuals could expect to receive higher total benefits as a function of opting for a personal retirement account.

¹⁷ Likewise, the income tax structure is considered progressive not because higher wage workers pay higher taxes in absolute terms, but because they pay a greater *share* of their total incomes.

In sum, Diamond and Orszag make two almost contradictory claims. They raise the worrying prospect of a “liability account” that saddles each worker with a “debt” to the system, while simultaneously claiming that “subsidies” to the accounts harm program solvency by making personal accounts a no-lose proposition. If so, it’s difficult to understand why workers should be so concerned about holding these “liability accounts.”

Price versus Wage Indexing of Benefits in Commission Plan 2

The Commission’s Plan 2 achieves balance in the tradition program by shifting the calculation of the initial benefits each new cohort of retirees receives from a formula known as “wage indexing” to one known as “price indexing.” Since 1977, the initial benefits each new cohort of retirees receives has increased by the rate of wage growth; hence, if wage growth were 3 percent, we could expect that new retirees this year would receive an average benefit 3 percent higher than that received by individuals who retired last year.¹⁸

Beginning in the year 2009, Plan 2 shifts to price indexing, under which the initial benefits each new cohort of retirees has received increases by the rate of inflation. The inflation rate is generally somewhat lower than the rate of wage growth.

Two things are obvious about this change to price indexing: first, since it does not begin until 2009, no one retiring prior to that date would be in any way affected; nor would existing retirees.

Second, since the average benefit for each cohort of new retirees would rise by at least the rate of inflation, traditional benefits would not be “cut” in any real sense.¹⁹ Comparisons to the annual adjustment of benefits for inflation that occurs after retirement are apt. A retiree does not consider it a cut if his benefits are raised annually at the rate of inflation; doing so *maintains* the real level of benefits, it does not cut them. Similarly, while price indexing reduces the growth of benefits, it always at least maintains them in terms of real purchasing power.

Price indexing by itself is sufficient to return Social Security to long-term solvency without increasing taxes. In effect, it increases benefits only at the rate that the current system can afford to increase them. However, Plan 2 gives larger increases to workers with the lowest wages. *Low-wage individuals would generally be better off under Plan 2 than under the current system, even if the current program did not face a financing crisis.*

Diamond and Orszag, however, attack price indexing as “a fundamental shift in the concept behind Social Security”:

Under current law, the benefit system is designed to maintain a constant “replacement rate” across generations: that is, to ensure that the percentage of wages that Social Security replaces when workers retire remains roughly constant from one generation to the next. ...A constant “replacement rate” across generations may seem like an abstract concept, but it serves the crucial purpose of allowing beneficiaries to share in the general

¹⁸ Following retirement, all workers would continue to have their benefits increased annually according to the rate of inflation.

¹⁹ Since workers would also have personal accounts, total retirement benefits under Plan 2 would rise over time, though not as quickly as the current benefit formula schedules.

increase in the standard-of-living that society as a whole experiences from one generation to the next. A focus on replacement rates also recognizes the psychological phenomenon by which families become accustomed to a given standard of living; substantial declines in income during retirement can pose difficult problems for families and individuals.

Diamond and Orszag are of course entitled to their view that Social Security must replace a constant share of a retiree's pre-retirement income, even if this must be accomplished at the cost of raising payroll tax rates to almost 20 percent of wages for workers living in 2075.

What is ironic in their presentation, however, is that Diamond himself was in the past a strong proponent of price indexing, going so far as to say that it would be irresponsible to maintain a wage-indexing formula. Diamond was a member of a government panel in 1976 (the so-called Hsiao panel, named after its chair William Hsiao of Harvard) that compared the wage indexing and price indexing approaches. The panel came out in favor of price indexing, calling it "fair and necessary."²⁰ As the panel's report pointed out:

The wage-indexing method provides a sharp tilt in favor of workers retiring in the future. The increases in benefits for workers already retired are limited to increases in the rise in the Consumer Price Index. Yet workers who retire five years later will receive increments due to both price changes and increases in real wages. This difference in retirement benefits can be substantial.²¹

The Hsiao panel report explicitly rejected the idea the replacement rates should be the sole criterion for appropriate benefit levels, as they are under Diamond and Orszag's present analysis: "The merit of seeking a benefit formula that undertakes to maintain the present distribution of replacement ratios is a source of doubt to this Panel."²²

The Hsiao panel elaborated:

"[T]he effects of any particular formula should be studied in terms of what the formula accomplishes in each of two related but distinct measure, these being (a) the purchasing power of the benefit, and (b) the relationship of retirement benefit to income covered for Social Security just before retirement, i.e., the 'replacement ratio.' Discussion of Social Security benefit structure has concentrated heavily upon the second of these as the criterion of reasonableness. But we believe it is just as important to discover whether the proposed formula succeeds in granting nearly equal purchasing power to comparable workers who retire at different times."²³

This is a sharp contrast to the current study, in which Diamond and Orszag declare replacement rates to be "crucial."

²⁰ Peter Diamond, James Hickman, William Hsiao, and Ernest Moorhead, "Report of the Consultant Panel on Social Security to the Congressional Research Service," August 1976, p. 23.

²¹ Ibid., p. 9.

²² Ibid p. 23.

²³ Ibid p. 21.

Diamond and the rest of the panel favored price indexing strongly enough that when President Carter was seen to be favoring the (now-implemented) wage indexing approach, Diamond and the other panel members wrote to the *New York Times* to chide him for fiscal and generational irresponsibility:

President Carter would be displeased with his predecessors if he were currently faced with the choice of cutting Social Security benefits for present recipients or raising the same amount of revenue as would be raised by an increase in the payroll tax rate of five percentage points. Yet that is precisely what the best current estimates say he is proposing to do to some future President...

*It appears to us that correction of overindexing by choice of a price indexing method would be greatly superior [to wage indexing].... Use of the price indexing method would eliminate the need for a tax rise when the percentage of retirees increases sharply early next century... While the price indexing method implies protection from inflation and a growth in benefits with the real growth of the economy, the wage indexing method calls for a much larger growth in benefits for future retirees at a time when the country may not be able to afford it. Use of the price indexing method would permit moderate tax and benefit increases to aid those recipients with greatest need as perceptions of those needs arise.*²⁴

This final passage is as cogent and articulate as anything the Commission could have said in favor of price indexing. Moreover, the same charges Diamond made against President Carter – of calling for “much larger growth in benefits for future retirees at a time when the country may not be able to afford it” – could today be made against those who wish to saddle future taxpayers with economic burdens they themselves are unwilling to bear today.

Just as important as the policy itself is when the policy was proposed to take place. The Commission’s Plan 2 would implement price-indexing beginning in 2009, when the average benefit for a new retiree is projected to be \$1,288. In 1976, when Diamond advocated a shift to price indexing, the average monthly benefit paid to retirees equaled only \$706 (in today’s dollars).

Even given a transition period, had the program Diamond advocated in the past been implemented, workers would receive total retirement benefits significantly smaller than those that would be paid under the Commission’s Plan 2. Moreover, under Plan 2 workers have the option of a personal account with which they could receive far higher benefits than under a price-indexed system alone. Under the proposal that Diamond supported, no personal accounts would be available.

Subsequent to the release of the Commission’s recommendations, Diamond disowned his prior support for price indexing.²⁵ Diamond argued that he had favored price indexing in the 1970s because the financing problems facing Social Security at the time were much greater than those at present. It is true that Social Security faced a short-term financing crisis at the time due

²⁴ Peter Diamond, James Hickman, William Hsiao, and Ernest Moorhead, letter to the *New York Times*, May 29, 1977, sec. 4, p. 14.

²⁵ “Will Voluntary Personal Accounts Save Social Security?” American Enterprise Institute Seminar Series in Tax Policy, April 5, 2002.

to an error in the benefit formula introduced in the 1972 amendments. But price indexing, which is extremely slow to take effect, would have done nothing to avert insolvency in the short term. Moreover, the wage-indexing alternative that Diamond and the rest of the panel argued so strongly against entailed long-term system costs barely higher than those projected by Social Security's actuaries today.²⁶ In the New York Times letter Diamond warned of a 5 percentage point increase in payroll tax rates; under the current program, workers would be subject to the equivalent of a 7 point increase in tax rates to pay the benefits the Diamond-Orszag baseline promises.²⁷

Risk-Adjustment of Investment Returns

Diamond and Orszag produce a modified benefit comparison in which they “adjust for the risk that is inherent in individual account portfolios (or in any investment in stocks).” Risk adjustment is not inappropriate on the whole, for the higher returns on market investments like stocks do not come without additional risk. If risk adjustment is to be undertaken, however, the current Social Security system should also be analyzed for political risk, that is, the chance that benefits promised to workers and retirees will not in fact be paid. This risk, it turns out, is substantial.

Diamond and Orszag risk adjust the returns from personal accounts by assuming that each account earns the equivalent of the government bond rate of return, regardless of whether it is invested in government bonds, corporate bonds or stocks. The Commission itself produced numbers for risk-adjusted returns, which Diamond and Orszag rely upon. The numbers, they claim, show that workers could expect total retirement benefits substantially below those of the current program.

However, these risk-adjusted personal account benefits should be compared to benefits from the current program adjusted for political risk. As we know, the current Social Security system cannot pay promised benefits past 2041. Hence, Americans face not just the risk but the certainty of either tax increases or benefit cuts. These are the two realistic baselines for comparison that Diamond and Orszag refuse to acknowledge or utilize.

When compared to a risk-adjusted Social Security system, the Commission Plans fare very well. A low-wage worker retiring in 2042 would receive a monthly benefit of \$853 (in today's dollars) from the Commission's Plan 2, assuming she invested only in government

²⁶ For instance, the wage indexing plan advocated by the Ford administration implied system costs in 2030 of 18.9 percent of payroll, in contrast to 17.24 percent projected in the 2002 Social Security trustees report. The Hsiao panel faulted the Ford administration's plan for leaving “a significant actuarial deficit in the financing of the OASDI system” and highlighted “the stability of the tax rates needed to finance promised benefits under this Panel's recommendation—a stability not enjoyed by other major recommendations that Congress is considering.” *Report of the Consultant Panel on Social Security to the Congressional Research Service*, p. 6.

²⁷ As a side note, Henry Aaron of the Brookings Institution, who has also attacked the Commission for proposing a change to price indexing, concurred with Diamond in supporting the policy. At the time he argued that price indexing “would leave more options open for spending the productivity dividend of economic growth. Congress could still raise pensions in the future, but it could also decide that other programs such as housing, health insurance, or defense have greater claims on available funds.” “Propping up Social Security,” *Business Week*, July 19, 1976, p. 34. As chairman of the 1978–79 Advisory Council on Social Security, Aaron again argued for price indexing, but the change was not adopted.

bonds. This total is 30 percent higher than what a solvent, risk-adjusted current program could pay her.

Clearly, when risk adjustment is applied uniformly, personal account-based reform plans once again come out ahead.

As a side note, while Diamond and Orszag acknowledge that risk adjustment must be applied to any market investment, including centralized investment by the government, advocates of government investment of the social security trust fund in the stock market have never applied this criterion. The Clinton administration, for which Orszag served as a policy advisor on Social Security, did not risk adjust the returns the trust fund would receive were it to be invested in the stock market, as the administration had proposed.²⁸

How would Diamond and Orszag keep Social Security solvent?

To their credit, Diamond and Orszag note in several places that “Social Security is running short-term surpluses but faces a projected long-term deficit.”

[S]ome combination of a reduction in benefits, an increase in revenue, and an increase in the rate of return earned on the reserves of the Social Security Trust Fund is required to bring the system back into balance. Since it is unlikely that a reform plan would restore long-term solvency solely through payroll tax increases, transfers from the rest of the budget, and/or the investment of Social Security reserves in financial instruments that yield a higher rate of return than Treasury bonds, restoring long-term balance to Social Security will likely involve some reduction in “replacement rates.”

That Diamond and Orszag at least acknowledge the problem and recognize the steps necessary to address it puts them above many account opponents, who prefer to pretend that nothing need be done about Social Security except defeat personal accounts. Moreover, most personal account opponents denounce any reduction in benefits versus those current promised, while Diamond and Orszag appear to accept the unsustainability of benefit levels promised under the current pay-as-you-go program.

However, the fact that Diamond and Orszag refuse to put forward their own comprehensive, actuarially-scored proposal makes their comparisons and analysis almost useless in practice. They accurately state, “A fundamental issue is whether the balance among the possible elements of a reform plan is appropriate.” But how are we to know whether the

²⁸ Similarly, former Wall Street executive Sen. Jon Corzine (D-NJ) said on the Senate floor Wednesday, “In the world I came from we used to put probabilities about what would happen. That’s called a risk-adjusted view of what returns would be... After all, the promise of the dollar backed by the full faith and credit of the United States government in your Social Security is a lot better than those risk-adjusted returns in stock market. I think that’s what the American people are looking for.”

However, Corzine apparently never applied Wall Street risk adjustment techniques to his *own* proposal for the government to invest the Social Security trust fund in the stock market in order to earn higher – though riskier – returns. It does not matter, according to Diamond and Orszag, whether equity investments are made individually or centrally; in fact, their evidence for the need for risk adjustment is an OMB decision to risk-adjust equity investments made by the Railroad Retirement System trust fund.

Commission's plans strike a better balance than alternative proposals if personal account opponents refuse to put those alternatives on the table?²⁹

For his part, Diamond has in other places suggested that he would force state and local workers to enter the system; raise the maximum wage subject to payroll taxes; increase taxes on benefits and eliminate the current tax exemption for low-income retirees; index benefits for life expectancy to about half the degree done in Plan 3; and phase in payroll tax increases.³⁰ This proposal, however, has never been analyzed for solvency or sustainability.

Orszag has not put forward his own proposal, even in outline form, though he was involved in formulating the Clinton administration's proposals. None of these proposals, however, achieved long-term solvency for Social Security.

If the two authors had put their own proposal for solvency on the table it would have allowed their readers to make a fair comparison between the Commission proposals and the authors' preferred alternatives. This comparison, coupled with their other analysis, could have served the Social Security debate by highlighting the options for change available and the priorities that can be put on each.

The tax increases and benefit reductions inherent to non-account based proposals would have made the Commission's plans appear more attractive by comparison. Hence, the only alternative Diamond and Orszag can offer is a hypothetical Social Security system that, as a matter of simple mathematics, cannot pay the benefits it has promised.

²⁹ It is not merely Diamond and Orszag who are guilty in this regard. Recently 50 Senators wrote to President Bush to state their opposition to the "benefit cuts" in the Commission Plans. Yet none of those 50 Senators has sponsored Social Security reform legislation that would enable the program to meet its promises.

³⁰ Peter Diamond, Remarks at "Will Voluntary Personal Accounts Save Social Security?" American Enterprise Institute Seminar Series in Tax Policy, Friday, April 5, 2002.