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The Politics of Reforming Social Security

R. DOUGLAS ARNOLD

What are the chances that Congress and the president will tackle the social security problem and enact reforms within the next several years? Does it seem more likely that they would adopt a comprehensive new system for retirement security or that they would approve more modest adjustments to the current system, returning the program to actuarial balance without altering its fundamental character? Are some kinds of reforms more politically attractive than others? These are important questions that deserve careful answers. This article addresses these questions within a general discussion of the political feasibility of alternative schemes for reforming Social Security.

Policy analysts often avoid questions of political feasibility, preferring to design programs that they believe will best achieve certain ends, while leaving it to politicians to "do the right thing." Sometimes this works nicely, and elected politicians enact analysts' handiwork. Quite frequently, however, the absence of early political analysis leads to unhappy outcomes. Sometimes Congress rejects not only the proposed policy but the notion of doing anything at all. Some would argue that this is what happened with President Bill Clinton's health-care package. A comprehensive plan designed by policy specialists without proper attention to political feasibility drove health-care reform off the governmental agenda. A second possibility is that Congress may start with policy analysts' most-preferred policy but quickly transform it into something that is unrecognizable to its early advocates and unlikely to achieve their intended purpose. The 89th Congress did this with President Lyndon Johnson's proposal to concentrate large sums of money in a few Model Cities by insisting that smaller sums be dispersed among 150 cities.[1] A third possibility is that Congress

[1] See R. Douglas Arnold, *Congress and the Bureaucracy: A Theory of Influence* (New Haven: Yale University Press, 1979), 165–206.

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may adopt a proposal that seems attractive, only to have the program's supporting coalition unravel once the program begins operating. Congress enacted the Medicare Catastrophic Coverage Act by overwhelming margins in 1988, for example, only to reverse itself a year later and repeal the entire program after beneficiaries protested the way costs were allocated.[2]

Early attention to the political feasibility of alternative schemes for reforming Social Security seems especially appropriate given the stakes. This is no ordinary program. Social Security is the cornerstone of retirement security for most Americans, with 60 percent of retirees drawing more than half their retirement income from this one program.[3] The long-term problems of Social Security are serious, however, and most experts counsel that the sooner Congress and the president fix these problems the better. Given these stakes, it makes sense to map carefully the political terrain that lies ahead, so that policy advocates do not make the kinds of mistakes that drive reform off the governmental agenda or push necessary changes far into the future.

Before addressing the central question of political feasibility, it is important to understand what political science can—and cannot—accomplish. Political scientists have no special expertise in predicting the behavior of specific individuals. They have no tools for forecasting what Bill Clinton, Newt Gingrich, or Dick Gephardt will decide to do tomorrow morning, where each will come down on a particular proposal, or whether in the midst of difficult negotiations one of them will decide to be intransigent or accommodating, visionary or parochial, statesmanlike or petty. What specific individuals choose to do and especially how institutional leaders decide to behave will surely affect decisions about Social Security, but unfortunately political scientists have no special tools for analyzing these things.

Political scientists do have tools for analyzing how lots of politicians—say the 535 members of the House and Senate—might behave when they choose among specific policy options. Analysis is possible for large groups of legislators, because many of the idiosyncracies that seem so pronounced when one focuses on individuals disappear when summed across several hundred legislators. Analysis is also aided by the fact that legislators face similar problems year after year. Politicians establish habits for dealing with recurrent problems, and these habits shape how they deal with just about every problem that comes their way.

Some observers of Congress emphasize all the changes that occur on Capitol Hill. Electoral tides sweep one party in, the other out. Retirements and electoral defeats change the cast of characters. Political scientists tend to emphasize constancy on the Hill. The sources of constancy are two—one institutional, the

[2] For an excellent account, see Richard Himelfarb, *Catastrophic Politics: The Rise and Fall of the Medicare Catastrophic Coverage Act of 1988* (University Park: Pennsylvania State University Press, 1995).

[3] Advisory Council on Social Security, *Report of the 1994–1996 Advisory Council: Reports of the Technical Panels* (Washington, DC: U.S. Government Printing Office [GPO], 1997), 287.

other electoral. The institutional fact is that Congress is a majoritarian institution in which legislators are equals. No legislator has constitutional authority over another; leaders serve at the pleasure of members; individual legislators are free to support or reject any alternative put before them. The electoral fact is that legislators retain their seats by their individual efforts to please their constituents. A seat in Congress is an individual franchise. As a consequence, legislators are extraordinarily attentive to what they hear from constituents, careful about how they deal with organized interests, and cautious when they cast major votes, calculating how specific votes might look in the middle of the next campaign if challengers decide to focus attention on them.[4]

The Agenda

Why is Social Security on the agenda for the first time in fifteen years? Why are policy makers considering modifying or replacing the program? Social Security was once such a regular item on the governmental agenda that no detailed explanation was really required. Between 1935 and 1973, Congress and the president enacted twenty-five Social Security laws—more than one bill every two years—as they transformed a relatively small retirement program, with initial tax rates of 1 percent each on employees and employers, into the mature program we know today, with tax rates of 6.2 percent.[5] During the final six years of this period, Social Security was constantly on the agenda, as Congress and the president responded to unusually high inflation by raising benefits seven times. Finally, in 1972, they placed Social Security on automatic pilot by enacting a provision that each year adjusts the wage base for changes in average wages and retirement benefits for changes in the consumer price index.

The 1972 law essentially removed Social Security from the regular governmental agenda. The program had reached maturity, and particularly as the economy stalled, there were no further pressures to expand it. Although insulated from inflation, Social Security was still vulnerable to other economic shocks and to long-term demographic changes. Social Security has returned to the governmental agenda only twice since 1972, each time because of actuarial imbalances. It first returned in 1975, after actuaries calculated that the program was facing a deficit within three years. The sources of the problem were two: some mistakes in drafting the original adjustment formula, which overcompensated for inflation, and economic stagnation which reduced revenues below their projections. After two years of debate, Congress and the president enacted a 1977 bill that phased in tax increases and recalibrated the inflation ad-

[4] On how the electoral connection shapes legislators' voting decisions, see David R. Mayhew, *Congress: The Electoral Connection* (New Haven: Yale University Press, 1974); John W. Kingdon, *Congressmen's Voting Decisions*, 3rd ed. (Ann Arbor: University of Michigan Press, 1989); and R. Douglas Arnold, *The Logic of Congressional Action* (New Haven: Yale University Press, 1990).

[5] For a summary of Social Security legislation, 1935 to 1977, see Martha Derthick, *Policymaking for Social Security* (Washington, DC: Brookings Institution, 1979), 429–432.

justment. Four years later, Social Security was again back on the governmental agenda when actuaries forecasted both short-term and long-term deficits. After two years of intense effort, Congress and the president adopted the 1983 reform bill, this time just a few months before the trust fund would have run dry and current revenues would have been insufficient to cover benefit checks. This bill included both tax increases for current workers and benefit cuts for future retirees.[6]

What is unusual about Social Security today is that it is *not* facing a short-term deficit. Indeed, the trust fund is larger than ever and growing steadily. The problem is entirely long-term. Government actuaries calculate that the system can pay all benefits until about 2032, after which the trust fund will be empty, and current revenues will only cover about three quarters of promised benefits.[7] The lack of any short-term crisis has profound implications for the politics of Social Security reform. First, there is nothing to force politicians to come to agreement about how to reform the system. Everyone may agree that reform is necessary and that early reform is desirable, but there is nothing to compel early action. No one doubted the urgency of reform in the early 1980s, yet it took two years and the prospect that benefit checks were about to be curtailed before politicians agreed to a specific package of reforms. Nothing focuses politicians' minds on problem solving and compromise more than the prospect that their constituents might be deprived of benefits at daybreak.

The lack of a short-term crisis has also made it possible for policy makers to consider comprehensive reforms of Social Security rather that the incremental fixes that are typical when the well is about to run dry. Although Social Security has long had its critics, it has been difficult for these critics to get their ideas and proposals on the table. Either Social Security was flourishing and no one wanted to hear from a spoilsport, or Social Security was facing a short-term crisis and no one had time to reinvent the system. The opportunity to develop and consider comprehensive reforms does not suggest that these plans have any advantage over more incremental reforms, only that for the first time since 1935 policy makers are open to considering alternative approaches to retirement security.

Policy Options

There is no shortage of plans for reforming Social Security.[8] In January 1997, the Advisory Council on Social Security proposed three separate plans, com-

[6] For the story of the 1983 reform, see Paul Light, *Still Artful Work: The Continuing Politics of Social Security Reform*, 2nd ed. (New York: McGraw-Hill, 1995).

[7] Two years ago, when the Advisory Council on Social Security was preparing its recommendations, the projected date of insolvency was 2029. For the most recent projections, see Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *The 1998 Annual Report* (Washington, DC: GPO, 1998), 4.

[8] On the various approaches to reforming Social Security, see Peter Diamond, "Proposals to Restructure Social Security," *Journal of Economic Perspectives* 10 (Summer 1996): 67–88; Edward M.

monly referred to as Maintain Benefits (MB), Individual Accounts (IA), and Personal Security Accounts (PSA).[9] Each plan was supported by a minority of the thirteen-member council. Other plans on the table include those associated with prominent organizations (for example, the Cato Institute), those drafted by various groups of scholars (Kotlikoff-Sachs), and those already introduced in Congress (Kerrey-Simpson).[10] The following discussion concentrates on five plans that represent the range of alternatives. Rather than using the confusing and overlapping names provided by their champions—personal security systems, personal security accounts, individual accounts, and the like—it is simpler to refer to them by the names of their principal advocates: the Ball plan, the Gramlich plan, the Weaver-Schieber plan, the Kotlikoff-Sachs plan, and the Ferrara-Cato plan.[11] A final section examines two recent proposals: the Kasich plan and the Moynihan plan.[12]

Although these five reform plans differ in many important respects, ranging from their basic organizing principles to myriad details of implementation, two differences are fundamental to questions about political feasibility. The plans differ in the extent to which they provide for advance funding of retirement benefits. They also differ in how all of this advance funding should be invested, whether in a centrally managed fund where risks and rewards are shared, or in various types of private accounts where individual workers select investment options and bear the risks and rewards individually.

Today's Social Security system is essentially a pay-as-you-go transfer program, with the contributions of current workers paying for the retirement benefits of current retirees. Although the system has a trust fund, it is relatively small and designed more to smooth out demographic fluctuations than to accumulate

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Gramlich, "Different Approaches for Dealing with Social Security," *Journal of Economic Perspectives* 10 (Summer 1996): 55–66.

[9] See Advisory Council on Social Security, *Report of the 1994–1996 Advisory Council: Findings and Recommendations* (Washington, DC: GPO, 1997).

[10] For a useful table summarizing the elements of seven plans, see Employee Benefit Research Institute, "Keeping Track of Social Security Reform Proposals: A Summary," *EBRI Notes* 17 (November 1996): 1–8.

[11] The Ball, Gramlich, and Weaver-Schieber plans are presented in Advisory Council, *Findings and Recommendations.* The other two plans are described in Laurence J. Kotlikoff and Jeffrey D. Sachs, "It's High Time to Privatize," *The Brookings Review* 15 (Summer 1997): 16–22; Laurence J. Kotlikoff and Jeffrey D. Sachs, "The Personal Security System: A Framework for Reforming Social Security" (presented to the Subcommittee on Social Security, House Committee on Ways and Means, *Hearings on the Future of Social Security for This Generation and the Next*, 105th Congress, 1st sess., 6 March 1997); and Peter J. Ferrara, "A Plan for Privatizing Social Security," *The Cato Project on Social Security Privatization* (Washington, DC: Cato Institute, 1997).

[12] Robert M. Ball, Edward M. Gramlich, Carolyn L. Weaver, and Sylvester J. Schieber were members of the thirteen-member Advisory Council on Social Security (1994–1996). Laurence J. Kotlikoff is professor of economics at Boston University, Jeffrey Sachs is professor of economics at Harvard University, and Peter J. Ferrara is an associate scholar at the Cato Institute. Members of Congress are Senator Bob Kerrey (D-NE), former Senator Alan K. Simpson (R-WY), Representative John Kasich (R-OH), and Senator Daniel Patrick Moynihan (D-NY).

vast sums for investment.[13] The trust fund is currently accumulating extra funds while members of the baby-boom generation are in their working years, but these reserves will be drawn down during their retirement years. The trust fund is invested exclusively in bonds of the United States government.

All five reform plans move Social Security in the direction of advance funding. Four plans include some type of individual accounts. The largest faction on the Advisory Council advocates a Maintain Benefits plan (the Ball plan) that would retain most of the system's pay-as-you-go character, while incorporating adjustments that would allow the trust fund to grow larger, be invested more aggressively, and thereby play a greater role in financing benefits.[14] At the other end of the spectrum, both the Kotlikoff-Sachs proposal and the Ferrara-Cato plan would phase out most of the current pay-as-you-go system and replace it with an advance-funded plan in which workers' contributions would be squirreled away in individual investment accounts. Another of the Advisory Council's proposals, the Weaver-Schieber plan, occupies a midpoint between these two extremes, with about half of all benefits provided by advance-funded, individually-directed Personal Security Accounts and the other half by a variant of the current pay-as-you-go system. The third of the Advisory Council's proposals, the Gramlich plan, occupies some of the space between the Ball and Weaver-Schieber plans, grafting a smaller version of advance-funded Individual Accounts on top of a reduced pay-as-you-go system.

The debate is vigorous between those who propose to privatize all or part of Social Security by establishing individual accounts and those who seek to preserve a collective system where risks and rewards are shared. At least for the purists—the complete privatizers and the strict preservationists—the debate reflects fundamentally different conceptions of what Social Security should be. The complete privatizers envision Social Security as just another pension plan. They believe that workers should be allowed to control how their compulsory contributions are invested just as they currently control how their voluntary contributions to IRA or 401(k) accounts are invested. They celebrate the fact that risk and reward would be concentrated on individuals. The preservationists insist on viewing Social Security as social insurance rather than just another pension plan. They believe that it is essential to have a collective system that provides a guaranteed floor of retirement security for all Americans and that protects each individual from the risk of having inadequate retirement income. They believe that the current system is appropriately sized and that benefits should not be reduced.

[13] The trust fund is currently equal to about 1.7 years of benefit payments. See Board of Trustees, *The 1998 Annual Report*, 127.

[14] Under present law, the trust fund would decline to zero in 2032, whereas under the Ball plan the trust fund would grow to about 4.5 years worth of benefits and then stabilize around that level. A fund of this magnitude could provide investment earnings equivalent to what an additional 2 percent payroll tax would supply. See Advisory Council, *Findings and Recommendations*, 172, 184.

If the debate were simply between the strict preservationists and the complete privatizers, then the preservationists would almost certainly prevail. Completely dissolving the safety net of social insurance and allowing individuals to manage all of their retirement assets is not a serious option given the broad public support for the idea of Social Security. But there are plenty of intermediate positions between strict preservation and complete privatization. The Gramlich and Weaver-Schieber plans, for example, are hybrids that call for partial privatization. They propose scaling back the size of the defined benefit system and creating a parallel defined contribution system that allows for some individual choice.

Social Security has long been conceived as part of a three-legged stool—the other two legs being employer-provided pensions and private savings—where the three legs together support the retirement needs of Americans. The partial privatizers are essentially asking whether the social insurance leg is too large. Although the question is always legitimate, it is especially so given all the changes that have occurred during the past two decades in the other two legs.[15] When the question was last raised in the 1960s and 1970s, a strong bipartisan consensus developed in favor of expanding the Social Security system. Today, as the deep divisions within the Advisory Council demonstrate, no consensus exists on the appropriate size of Social Security—at least in its current form.

Conflicts over the question of privatizing Social Security are intense. Questions about the appropriate size and scope of government are inherently ideological, partisan, and conflictual. But the whole question of moving toward advance funding is itself politically troublesome. Although questions about advance funding may appear tame by comparison to questions about establishing individual accounts, since advance funding ignites neither ideological nor partisan passions, a careful analysis of the politics of moving toward advance funding demonstrates the fallacy of this conclusion. Advance funding is troublesome for politicians of every partisan and ideological persuasion. Since advance funding is an essential component of every proposal for privatizing even a portion of Social Security, this makes adopting privatization more difficult politically than the ideological conflict between individual choice and social insurance suggests.[16]

The Politics of Funding Decisions

Advance-funded retirement systems have several advantages over pay-as-you-go systems. Among other things, they promote national savings and thus eco-

[15] See David Cutler, "Reexamining the Three-Legged Stool" in Peter Diamond, David Lindeman, and Howard Young, eds., *Social Security: What Role for the Future?* (Washington, DC: Brookings Institution, 1996).

[16] Advance funding is not logically necessary for privatization. For example, Latvia created a privatized but unfunded pension system. But such hybrid schemes are both rare and difficult to explain to politicians and citizens. On the distinction between privatization and advance funding, see John Geanakoplos, Olivia S. Mitchell, and Stephen P. Zeldes, "Would a Privatized Social Security System Really

nomic growth, and they help insulate the financing of retirement plans from the effects of large demographic shifts.[17] From a political perspective, however, they have one large liability: They deliver no benefits in the near term for which politicians can claim credit. As their name implies, the costs are now, the benefits far in the future. Few politicians enjoy imposing costs on their constituents without also delivering some fairly immediate benefits—especially if there is an easier way.[18]

Social Security actually began as an advance-funded system.[19] The original plan, enacted in 1935, imposed a one-percent payroll tax, but promised no retirement benefits until 1942. Perhaps the costs were sufficiently small that they were not seen as a major political liability; perhaps it helped that contributors were promised that they could start collecting retirement benefits in just a few years. By 1939, policy makers had begun the transformation to a pay-as-you-go system, first by accelerating workers' eligibility for benefit payments to 1940, then by adjusting benefits upward so that retirees received far more than their own contributions could have earned, and finally by postponing planned tax increases so that the trust fund would remain only a small buffer, not a large investment fund.

The transformation from an advance-funded system to a pay-as-you-go system was easily accomplished, because it united a diverse coalition of interests. Program enthusiasts sought to deliver more benefits to retirees as soon as possible. Many legislators sought to minimize the tax burden on current workers by deferring tax increases until they were absolutely necessary to fund current retirees' benefits.[20] And some conservatives were opposed to a large trust fund, fearing, according to Senator Arthur Vandenberg (R-MI), "such an unmanageable accumulation of funds in one place in a democracy."[21] The same political logic that allowed for the transformation to a pay-as-you-go system also fueled the program's vast expansion over the next three decades. Because workers greatly outnumbered retirees, modest increases in the payroll tax, phased in

Pay a Higher Rate of Return?" in R. Douglas Arnold, Michael Graetz, and Alicia H. Munnell, eds., *Framing the Social Security Debate: Values, Politics, and Economics* (Washington, DC: Brookings Institution, forthcoming).

[17] On the economics of advance funding, see Peter Diamond, "Macroeconomic Aspects of Social Security Reform," *Brookings Papers on Economic Activity* (2, 1997): 1–87.

[18] Politicians are not the only people who behave in this fashion. Many consumers use installment debt to maximize current benefits and minimize current costs. Perhaps politicians adopted advance funding for Social Security in the 1930s because advance funding better corresponded with the values of the day, just as the subsequent movement towards pay-as-you-go funding corresponded with the buy-now-pay-later mentality of the 1960s and 1970s.

[19] For a superb political analysis of Social Security from 1935 to 1977, see Derthick, *Policymaking for Social Security.*

[20] Ibid., 215.

[21] Ibid., 232.

gradually, covered large increases in retirement benefits.[22] The incremental costs for workers were small, the incremental benefits for retirees large.

Although policy makers gradually replaced an advance-funded system with a pay-as-you-go system, they retained the original rhetoric. They spoke in the common language of insurance, not in economists' language of transfer payments. The vocabulary of insurance was not only familiar, it was in many respects appropriate, because policy makers were creating *rights* to benefits for workers who paid their dues.[23] Most people do not understand exactly how various types of insurance are funded, including casualty, health, and life insurance. What they do know is that by paying premiums they acquire rights to have future losses covered by insurance companies. By using similar language for retirement security, policy makers created similar rights. These new rights were not stated in a legal contract to be enforced by the courts, but as a social contract to be enforced by elected politicians subject to the court of public opinion. Mere transfer payments could be eliminated by future politicians, but Social Security benefits were different. They were earned rights, and no future politician could eliminate them without the consent of those who had paid their dues.[24]

The Politics of Advance Funding

Moving from the original advance-funded Social Security system to a pay-as-you-go system was relatively easy. Accelerating benefits and postponing costs is one of the easiest things that politicians do. The difficulties arise when one attempts to reverse gears and reestablish advance funding as the organizing principle for retirement security. In order to do so, one must fund both systems for a while, simultaneously setting aside money for current workers while honoring all the existing obligations to retirees, near retirees, and all those who have paid substantial sums into the current system. These obligations are immense. One estimate is that the program's unfunded liability to current workers and retirees is in the neighborhood of $9 trillion.[25]

[22] The number of workers per beneficiary declined from forty-two in 1945, to seventeen in 1950, nine in 1955, five in 1960, and four in 1965. It reached its current level of 3.3 workers per beneficiary in 1975. See Board of Trustees, *The 1998 Annual Report*, 122.

[23] According to Martha Derthick, "Social Security was presented to the public as a program in which the worker takes care of his own future, gets back at least what he has paid for, and is entitled to get it back as a right." Derthick, *Policymaking for Social Security*, 289.

[24] All of the reform plans recognize the sanctity of these rights. Even the plans that seek to replace the current Social Security system with something completely different recognize that they must provide benefits over the next six or seven decades for all workers and retirees who have been part of the pay-as-you-go system.

[25] Recalibrated in terms of taxes, it would require a tax of 1.5 percent of taxable payrolls for about seventy years to eliminate an unfunded liability of $9 trillion. See Advisory Council, *Findings and Recommendations*, 109.

The Kotlikoff-Sachs plan is clearest about what it would require to satisfy existing obligations while concurrently allowing workers to direct their own contributions into individual investment accounts. They propose a federal sales tax that "would begin below 10 percent and would decline to a permanent level of roughly 2 percent within 40 years."[26] Since the permanent tax of 2 percent is to fund a safety net for the poor, the remainder, perhaps 7 or 8 percent initially, is to pay transition costs. The political difficulties of establishing such a large tax are clear. First, it would be the largest new tax in American history, imposed at a time when "no new taxes" seems closer to the governing philosophy. Second, it would procure for the federal portfolio a form of taxation long reserved for states and localities, who would resist any invasion of their turf. Third, a sales tax, unlike the current payroll tax, would be a tax on retired citizens. It is not likely to be popular with retirees or with the American Association of Retired Persons, a group that probably has the power to scuttle any plan that it finds unacceptable.[27] Finally, members of Congress still recount the tale of how Al Ullman (D-OR), chair of House Ways and Means, was defeated at the polls after championing a national value-added tax as the solution to the federal deficit.[28] Creating a new broad-based tax is more difficult for politicians than increasing an existing one. In short, both the size and the form of the transition tax proposed by Kotlikoff and Sachs highlight some of the political difficulties associated with moving toward an advance-funded system.

The proponents of advance funding are not naive. They know that neither citizens nor policy makers will be attracted by transition costs of this magnitude. Their argument is that the benefits of moving to advance funding would be immense and that the benefits would more than justify the admittedly large costs. The principal advantage of advance funding is that it would increase national savings, and these savings would stimulate economic growth.[29] A second advantage is that workers would eventually pay less for a given bundle of retirement benefits, because their benefits would be based on their own contributions as well as earnings on these contributions.

Estimating the costs and benefits of moving to an advance-funded system may demonstrate beyond a reasonable doubt that total benefits would eventually exceed total costs. The problem is that neither citizens nor politicians tend

[26] Kotlikoff and Sachs, "It's High Time to Privatize" and "The Personal Security System."

[27] Kotlikoff and Sachs note that the poorest senior citizens—those who are totally dependent on Social Security—would be insulated from the new tax, because Social Security benefits would continue to be indexed for price changes. All other senior citizens, however, would suffer declines in their living standards because other forms of retirement income are not indexed. Although Kotlikoff and Sachs argue that compelling senior citizens to pay a share of Social Security's unfunded liability is "intergenerationally equitable," it is not an argument that many elected politicians are likely to find appealing.

[28] See Arnold, *The Logic of Congressional Action*, 45–46.

[29] On the effect of Social Security reform on private and national saving, see Eric M. Engen and William G. Gale, "Effects of Social Security Reform on Private and National Saving" in Steven A. Sass and Robert K. Triest, eds., *Social Security Reform: Links to Saving, Investment, and Growth* (Boston: Federal Reserve Bank of Boston, 1997).

to evaluate policy alternatives by comparing total costs and benefits over an extended period of time.[30] Politics is much more about the timing and incidence of costs and benefits than about totals, and much more about the degree to which specific costs and benefits can be traced to politicians' individual actions. Because it is easier for citizens and politicians to estimate the incidence of costs and benefits in the short-term, and because it is easier for citizens to connect short-term costs and benefits to politicians' individual actions, politics invariably revolves around these short-term effects. Both citizens and politicians tend to undervalue long-term effects when they evaluate policy alternatives.

Applying this logic to the Kotlikoff and Sachs plan, one sees that all workers and many retirees would incur large costs in the short-term, and these costs would be directly traceable to the actions of individual legislators who supported their imposition. In contrast, the benefits would either be diffuse benefits, such as economic growth, or somewhat higher retirement benefits that would appear only in the long term. Most citizens would never trace either type of benefit to the actions that individual legislators took years before to produce them. In short, legislators could face electoral retribution for imposing easily traceable early-order costs, while it is doubtful that they would ever be rewarded for delivering such general benefits as economic growth and prosperity or such later-order benefits as the higher investment returns of individual retirement accounts.

Transition Costs

The point is not that it is impossible to reestablish a Social Security system based on advance funding. The point is that it is not yet in legislators' self-interest to impose the necessary transition costs. Reform is possible only when large majorities of Americans come to understand and accept the nature of the sacrifices that would be required to pay for the transition. Legislators will not enact this kind of reform just because they believe that advance funding is a good idea. Most legislators are unwilling to forfeit their careers to advance even a very good idea. Proponents of these reforms need to be honest with the American people, stating that whatever large benefits would be generated by adopting an advance-funded system would not be immediate. The benefits would be long-term; and until then, workers (and perhaps retirees) would pay increased costs.

Some proponents of privatizing Social Security claim that large majorities of Americans already support full-scale privatization. Michael Tanner reports on a 1996 poll in which 69 percent of registered voters supported a detailed privatization plan, while a mere 12 percent opposed it.[31] Although the poll ap-

[30] For a full theoretical treatment of the issues in this paragraph and the next, see Arnold, *The Logic of Congressional Action.*

[31] See Michael Tanner, "Public Opinion and Social Security Privatization," *The Cato Project on Social Security Privatization*, (Washington, DC: Cato Institute, 1996), 4–5.

pears to have been professionally administered in terms of sample size and the like, the 200-word description of a privatized system that prefaced the actual question failed to mention transition costs. It summarized all the benefits of privatization, along with "no reduction in benefits for current Social Security recipients"; but it neglected to mention the sacrifices required to pay for both systems. Politicians will not be fooled by such nonsense. Polls that emphasize benefits and ignore costs tell us nothing more profound than that everyone likes a free lunch.

Proponents of advance funding need to be clear and precise about the transition costs. Kotlikoff and Sachs pass this test with ease. In contrast, the Ferrara-Cato plan attempts to show that "the transition can be financed without new taxes and without cutting benefits for today's recipients."[32] The miracle of a costless transition is justified in nearly a dozen ways, my favorite being: "Any remaining transition costs should be financed by cutting other government spending, much of which is wasteful and even counterproductive. Reducing it will not amount to a significant cost."[33] Ferrara has in mind cutting about $60 billion per year.[34] No matter how insignificant he believes these expenditures to be, cutting budgets is never an easy task, especially after the extensive budget cutting of the past decade. It is a mistake to pretend that there are no significant transition costs.

The proponents of moving toward an advance-funded system also need to be clear about who will pay for the transition. The notion that everybody—and every age cohort—can be better off during the transition is implausible. Martin Feldstein poses the distributional question starkly: "During the transition, which are the age groups that win and which are the age groups that lose?"[35] Feldstein and Samwick analyzed one possible transition scheme and concluded that it would take about nineteen years for the cost of funding two systems to drop below the cost of funding the current system alone.[36] The bottom line by age cohort: "Those who are retired when the transition begins are completely unaffected. Those who are at least 45 years old will always face a higher combined mix of taxes and PRA [personal retirement account] contributions. Those who are younger will face a higher mix for 19 years and then a lower mix. The younger they are, the more likely that the present value of the combined payments will be lower in the transition than in the baseline."[37]

[32] Ferrara, "A Plan for Privatizing Social Security," 1.

[33] Ibid., 14.

[34] It is reminiscent of the magic asterisk in President Ronald Reagan's first budget that also referred to unspecified future expenditure cuts of $60 billion annually. It was far easier to assume that such cuts would be made than to make them. See William Greider, *The Education of David Stockman and Other Americans* (New York: E. P. Dutton, 1982), 36.

[35] Martin Feldstein, "Transition to a Fully Funded Pension System: Five Economic Issues," NBER (National Bureau of Economic Research) Working Paper No. 6149 (1997): 20.

[36] Martin Feldstein and Andrew Samwick, "The Transition Path in Privatizing Social Security," NBER Working Paper No. 5761 (1996); Feldstein, "Transition to a Fully Funded Pension System," 11.

[37] Feldstein, "Transition to a Fully Funded Pension System," 21.

More studies of this type would be useful, with additional studies investigating alternative transition schemes and making alternative assumptions about economic returns. Although it may also be useful to estimate the distributional effects of increased economic growth, these estimates need to be separate from estimates of the distributional effects of transition costs. The transition costs are certain and directly traceable to legislators' actions, whereas increased economic growth is more speculative and completely untraceable to legislators' decisions.

The reason why proponents of advance funding must be clear about who would pay for the transition is that opponents are certain to focus on the issue of costs. Pretending that everyone will profit is implausible and could easily undermine the legitimacy of a reform proposal. That was the fatal error made by the proponents of the Medicare Catastrophic Coverage Act of 1988, who failed to prepare senior citizens for the fact that some of them would be worse off.[38] A better strategic model for enacting advance funding would be the decade-long effort to balance the federal budget. No one pretended that the transition to a balanced budget was costless. The debate was about who should sacrifice, who should pay higher taxes, and who should have their favorite benefit programs shaved, slashed, or terminated.

Policy makers can also modify the incidence of transition costs. Total costs may be fixed, but their incidence by income and age is a matter of choice. Policy makers can also choose to phase in transition costs gradually. Advocates of advance funding often recommend that taxpayers swallow large doses of bitter medicine as quickly as possible so that the benefits would accrue rapidly. Politicians are more likely to prefer gradual transitions, beginning with small doses and slowly increasing the dosage over time. Gradualism was the approach that policy makers adopted in 1935 when they first instituted Social Security. Gradualism was also the approach that policy makers employed over the past decade when they moved the federal budget toward balance. Establishing what should be the proper transition period is not a matter in which policy experts have a comparative advantage, other than to show the relationship between the pace of sacrifice and the likely flow of benefits. The length of the transition period is a political choice, and it is best left to politicians who are skilled in estimating the rate at which their constituents can tolerate increased costs.

The General Problem of Costs

The analysis of the politics of replacing the current pay-as-you-go system with one based on advance funding has focused on transition costs, because these costs are the principal impediment to reform. Imposing costs is a general problem, however, and one that all reformers must face. The current system is not adequately funded, and there is no way to fix it without imposing costs on either

[38] Himelfarb, *Catastrophic Politics.*

today's generations or future generations. Before analyzing how other reform plans propose to apportion these costs, it will prove useful to examine how policy makers have allocated Social Security costs in the past.

Policy makers' aversion to imposing costs is not unique to the 1990s. From the very inception of Social Security, policy makers have been careful about how they apportioned costs. Gradualism has been the key to every single decision about costs from 1935 to 1983. The original Social Security Act, which imposed a payroll tax of 1 percent beginning in 1937, contained a gradual schedule for increasing the tax to 3 percent in 1949. But even this twelve-year schedule proved too rapid for politicians. Congress repeatedly slowed the schedule, moving the first scheduled increase from 1940 to 1950, and moving the original 3-percent ceiling to 1960.[39] Although Congress eventually increased the payroll tax to 6.2 percent, this was accomplished in twenty separate steps, averaging only 0.26 percentage points per step. Over the entire fifty-four-year period required for reaching the present tax rate, Congress increased taxes by less than 0.10 percentage points per year.[40] In short, policy makers increased costs as slowly and imperceptibly as possible.

The initial decision to impose identical payroll taxes on workers and employers was another way to make costs less perceptible. Economists can argue all they want about whether workers ultimately pay the employers' share too with foregone wages, but politicians know that workers perceive only the part that is deducted from their wages. Workers are unlikely to perceive either the employers' share or something as nebulous as foregone wages. The one group that would have noticed that they were paying both employee and employer taxes was spared having to do so. From 1951 to 1983, self-employed workers paid only about three quarters of the combined employee and employer rates.[41] Only under the pressure to find revenue to rescue Social Security in 1983 did Congress eliminate the special rate for self-employed workers, and even then, Congress created a seven-year transition period before the self-employed were brought up to parity with the combined tax rates for ordinary workers.[42]

[39] Derthick, *Policymaking for Social Security*, 429-431; Board of Trustees, *The 1998 Annual Report*, 33.

[40] Only four of the twenty tax increases between 1937 and 1990 were as large as 0.5 percentage points (1950, 1954, 1960, 1963). For a list of tax rates by year, see Board of Trustees, *The 1998 Annual Report*, 33–34.

[41] Congress began charging self-employed workers 75 percent of the combined rate, but it allowed the rate to dip as low as 69 percent between 1973 and 1980. Board of Trustees, *The 1998 Annual Report*, 33.

[42] Actually, Congress established parity in tax rates effective 1984, but it also granted self-employed workers an income tax credit to offset part of the increase. The credit was not phased out until 1990. Self-employed workers are currently allowed to deduct the "employers" half of the payroll tax from taxable income, just like any other employer. Of course, this tax deduction is much less valuable than either the original reduced tax rate for self-employed workers or the transitional tax credit. See *Congressional Quarterly Almanac*, *1983* (Washington, DC: Congressional Quarterly, 1984), 662.

The 1983 reform bill was a masterpiece at imposing costs as gradually and imperceptibly as possible.[43] The seven-year phase-in of both parity for the self-employed and a higher payroll tax for everyone was accompanied by reducing benefits for retirees in the distant future.[44] The normal retirement age was increased from 65 to 67, and early retirement benefits were cut from 80 percent to 70 percent of full benefits (both changes phase in between 2003 and 2027). Even current retirees had their benefits reduced modestly. Cost-of-living adjustments were delayed for six months for all retirees, and upper-income retirees had some of their tax-free Social Security benefits transformed into taxable income. It was a classic share-the-pain strategy, imposing costs on workers and retirees alike. But the pain was administered as slowly as possible.

Advisory Council Plans

Each of the three Advisory Council Plans is a complicated amalgam of individual provisions for restoring actuarial balance. Each has a different plan for apportioning costs among workers, retirees, and future retirees. The most striking difference between the plans, however, is how they propose to increase taxes on workers and employers. Although all three plans propose increasing Social Security revenues by about 1.6 percent of covered payrolls, they differ in who would pay the incremental costs and when the payments would begin. The Gramlich plan would require an immediate increase in workers' contributions of 1.6 percent of earnings; employers would face no additional costs. The Weaver-Schieber plan would require an immediate increase in workers' and employers' contributions of 0.76 percentage points each; both increases would be eliminated after seventy-two years. The Ball plan would require that both workers' and employers' contributions increase 0.8 percentage points in the year 2045.

The Gramlich plan is most out of line with how Congress has apportioned Social Security costs in the past. Workers would bear directly all the incremental costs. The traditional parity between workers' and employers' contributions would be broken for the first time since the program's inception. It is hard to imagine any political advantages in breaking a link that has long been accepted by both business and labor, especially given the enormous political liabilities of doing so. As sure as the sun rises, opponents would claim that the provision was designed to soak poor- and middle-income workers while protecting rich corporations from sharing the burden. Arguments that imposing costs directly on workers was a better way to increase national savings would fall on millions

[43] Light, *Still Artful Work*; and *Congressional Quarterly Almanac*, 658–663.

[44] Strictly speaking, legislators voted to accelerate the imposition of tax increases that were originally passed in 1977 and scheduled to be phased-in between 1979 and 1990. Since the acceleration generated about $40 billion in additional revenues, it was a genuine tax increase, even if it did not raise the 1990 rate above what it would have become in the absence of the reform bill. See Light, *Still Artful Work*, 180.

of deaf ears, as would arguments that workers eventually pay employers' share of the payroll tax through forgone wages. Breaking the link between workers' and employers' contributions would also increase the likelihood of partisan conflict, because one party has long been associated with business, the other with labor.

Moreover, by concentrating all of the incremental costs directly on workers, the Gramlich plan would require an enormous increase in workers' contributions. An immediate increase of 1.6 percentage points is more than three times greater than any increase in the history of Social Security.[45] It amounts to a 26 percent increase in the current payroll tax of 6.2 percentage points. At least on that count, the Weaver-Schieber plan is more attractive. By retaining the traditional link between workers' and employer's contributions, their plan would require an increase in workers' payments of only 0.76 percent of earnings. But even that rate is much larger than any increase in the history of Social Security. The point is not that it would be impossible for legislators to approve either the Gramlich or Weaver-Schieber rates. The point is that the designers of these two plans have made it unusually difficult for legislators to impose the level of costs that are essential for restoring actuarial soundness and moving toward advance funding. Recall that in 1983, when the well was about to run dry, legislators required a seven-year phase-in for an 0.8 percentage point increase in workers' contributions. Why, when the well is not scheduled to run dry until 2032, would legislators approve an immediate increase of either 1.6 or 0.76 percentage points? Why not employ the age-old strategy of gradualism?

Strictly speaking, the 1.6 percent increase in workers' payments under the Gramlich plan would not be a tax. According to the plan's proponents, it would be a contribution. Workers' contributions would be held by the government in individual accounts that would be invested in one or more indexed stock or bond funds; at retirement, both the contributions and the investment earnings would be used to purchase indexed annuities. Calling the payment a contribution rather than a tax, however, does not transform fundamentally the politics of imposing pain. When the government mandates that workers forgo current consumption, it makes more difference how much consumption is to be forgone than what the mandatory payment is called.[46] When the government mandates that workers keep their contributions in government-approved accounts until retirement and then mandates that the contributions be used to purchase government-approved annuities, the difference between a contribution and a tax becomes even narrower.

The assumption that citizens prefer making mandatory contributions to individual accounts over paying a higher payroll tax would be on firmer ground if the actual choice were between alternative payments of approximately equal

[45] See footnote 40.

[46] If the current Social Security system were somehow dissolved and the 6.2 percent payroll tax were transformed into a mandatory 6.2 percent contribution, would citizens across the land celebrate the elimination of a 6.2 percent tax?

size. Direct ownership is highly valued in American society; and, all else equal, people might prefer sending their money to individually-named accounts rather than to a giant collective account. The problem is that no one is being asked to choose between a tax and a contribution of the same magnitude. The choice is between an immediate contribution of 1.6 percent of wages under the Gramlich plan and a tax half as large and imposed a half century later under the Ball plan. If citizens really do prefer a large, immediate, mandatory contribution to a much smaller tax imposed far in the future (and no reliable evidence exists one way or the other), then it must be because they believe that the benefits from a contribution to an individual account are vastly more certain than the benefits from a tax. The appropriate question is how much extra are citizens willing to pay to increase their sense of confidence that benefits will be delivered far in the future? Since advance funding is crucial to establishing individual accounts, this is just a variant of the more general question concerning how much citizens are willing to pay to finance the transition to advance funding.

The Weaver-Schieber plan makes an even greater commitment to advance funding through defined-contribution accounts. It would redirect into personal security accounts 5 percentage points of the 6.2 percent that workers currently pay in Social Security taxes, while adopting a temporary transition tax of 0.76 percentage points each on employees and employers to cover obligations under the current pay-as-you-go system. As previously discussed, the Weaver-Schieber plan has a more politically realistic mechanism for increasing taxes than the Gramlich plan, because it retains the current parity between employer and employee contributions that allows workers' direct contributions to be half as large. The fact that the transition tax would be temporary is also a nice feature; but a seventy-two-year transition period offers no political advantages, because all the benefits would be enjoyed by generations not yet born.

The Ball plan requires no immediate tax increase, because it takes only a tiny step toward advance funding. Advance funding appears in this plan not by establishing individual investment accounts and finding new revenue to fill them, but by incorporating various small adjustments that would allow the current trust fund to grow larger and be invested more aggressively. The eventual tax increase of 0.8 percentage points each for workers and employers in 2045 is designed more to keep Social Security from again drifting out of balance as life spans continue to increase than it is to provide additional revenue for advance funding. Legislators should have no trouble approving a deferred tax increase of this magnitude, since the tax would never be imposed during their watch.

Despite the similarities among the three plans, with each proposing to increase Social Security revenues by about 1.6 percent of covered payrolls, the plans propose strikingly different routes toward that target. Surprisingly, the Gramlich plan, which was designed to be a moderate alternative between the other two, is the least graceful in imposing new taxes. The Weaver-Schieber plan, which proposes the most radical redesign of Social Security, is more politi-

cally adept at dealing with transition costs, because it retains the traditional parity between workers' and employers' contributions. And the Ball plan shows that it might be possible to incorporate additional advance funding in the current system without increasing taxes in the near term.

Other Costs

The analysis of the various reform plans has focused heavily on how they raise new revenue, because this is the most difficult aspect of moving toward advance funding. Imposing large, traceable, early-order costs on citizens is one of the toughest things that elected officials ever do. The three reform plans impose lots of other costs too, but none of these provisions are quite as difficult to accomplish as raising taxes for all workers. For example, all three plans forcibly enroll in the Social Security system all new state and local government workers. The three plans wisely steer clear of forcing current state and local employees to join the system, since such a provision would impose large, traceable, early-order costs on a well-organized group of workers that is politically active. By limiting the provision to newly hired workers—people who are not yet aware of their condition—the plans minimize the probability of electoral retribution. Current estimates are that this provision alone would eliminate about 10 percent of Social Security's long-range actuarial imbalance, in part because young government workers would contribute for many years before collecting benefits, and in part because many of these workers would have received some Social Security benefits anyway, based on other employment before, during, or after government service.[47]

All three plans would also impose costs on current retirees and future retirees. Current retirees would bear the lighter burden. None of the plans would directly reduce their benefits—something that would be large and noticeable to all. Instead, the plans would gradually alter the way in which Social Security benefits are taxed and then redirect the consequent income tax revenues into the Social Security trust fund. Gradualism and the fact that these tax provisions would affect only some retirees help to make them politically more palatable. These provisions also continue a trend, initiated in the 1983 reform plan and expanded in the 1993 budget bill, to tax as ordinary income a portion of Social Security benefits. All that is at stake is the precise location of an already existing line between taxable and tax-free benefits.

The three plans use various means for imposing costs on future retirees. The Ball plan proposes changing the benefit formula. The proposed change would be gradual and, given that most people don't understand the benefit formula anyway, future retirees would be unlikely to trace their slightly dimin-

[47] Advisory Council, *Findings and Recommendations*, 20, 181–183.

ished incomes to legislators' actions.[48] The Gramlich plan proposes even larger changes in the benefit formula, as well as gradual increases in the normal retirement age. The Weaver-Schieber plan proposes gradually replacing the current benefit formula with a flat-rate benefit beginning with workers younger than 55. Finally, all three plans would subject future retirees to the same kinds of gradual changes in the way Social Security benefits are taxed that would first affect current retirees.

All three plans seem to accept the notion that reducing benefits should be a gradual process. Gradualism allows everyone to readjust their affairs, and it minimizes the chances that anyone would notice any dramatic reduction in benefits that might stimulate a search for politicians to hold accountable. The surprise is that the Gramlich and Weaver-Schieber plans do not recognize the same political need to impose tax increases as gradually as possible. Perhaps in their zeal to move toward an advance-funded system as rapidly as possible they neglected the political imperative to impose all pain as slowly and imperceptibly as possible.

Investment Decisions

The three plans differ most significantly in how they propose to invest all this advance funding. Before discussing the investment options, it is important to note that we are now entering terra incognita. Congress has had plenty of experience deciding how to raise payroll taxes, adjust benefit levels, extend retirement ages, and restrict tax exemptions; and these past experiences help to inform an analysis of how legislators might handle similar provisions today. But Congress has never before chosen between polar opposites as the Weaver-Schieber plan, which introduces defined-contribution accounts with individual control over investment and distribution, and the Ball plan, which seeks to preserve the essential character of the current defined-benefit system. The Ball and Weaver-Schieber plans clearly rest on very different philosophies about how to organize a public pension system and about the trade-offs between universal retirement security and the importance of individual choice. What is yet to be determined is how these differences will play out politically.

The Ball plan has the advantage of familiarity. People can judge the proposed incremental changes against a well known entity. The overall package is right out of the 1983 playbook. It is a carefully calibrated collection of incremental changes that would not be very popular individually but that many people can accept as a package deal in order to preserve a highly valued program.

[48] The proposal is to increase the benefit computation period from thirty-five to thirty-eight years, which would reduce benefits by an average of 3 percent. Advisory Council, *Findings and Recommendations*, 25.

The one innovation is the proposal to consider investing the trust fund in the stock market.[49] This is also the plan's most controversial provision. The controversy has nothing to do with the riskiness of the stock market. Given that most private pension funds and most state and local pension funds are heavily invested in the stock market, it is difficult to sustain an argument that the largest pension fund in the country should be denied the higher yields of equities or the substantial advantages of diversification. The controversy is about whether it is healthy for the federal government to own a larger share of corporate America than any other shareholder. Under one plausible scenario, the Social Security trust fund would own about 5 percent of all corporate equities by the year 2020.[50] Direct investments of this magnitude could give the government power in corporate affairs beyond what it already exercises with its tax and regulatory authority.

It is relatively easy to devise mechanisms to allow the federal government to invest in private equities without acquiring additional power over private corporations. The government could decide to invest only in index funds and it could renounce all voting rights.[51] It could create a governing board that is as far removed from politics as possible—something like the Federal Reserve Board. Indeed, it seems likely that any plan to invest trust fund assets in the stock market would have to include these kinds of procedures in order to forestall the overwhelming opposition of corporations, corporate executives, and millions of citizens who believe that the federal government has no business using investment decisions or voting rights to interfere with corporate affairs.

The problem is that government cannot permanently establish a policy of passive investing or passive voting, because a future law can always repeal an existing one. No Congress can bind succeeding Congresses. So the question boils down to whether citizens are comfortable with a plan that includes the possibility that a future Congress might interfere with investment decisions or corporate governance. The issue is sufficiently new that it requires an active debate about how serious is the problem, how large is the probability of governmental interference, and how best to forestall it.[52] The best protection against

[49] Although the Ball plan does not explicitly endorse investing in equities, the actuarial projections that compare it with the other two Advisory Council plans assume that 40 percent of the trust fund would be invested in equities by 2015. Without this assumption, the Ball plan would be underfunded and additional tax increases or benefit cuts would be required. See Advisory Council, *Findings and Recommendations*, 80–86, 166.

[50] P. Brett Hammond and Mark J. Warshawsky, "Investing Social Security Funds in Stocks," *Benefits Quarterly* 13 (3rd Quarter 1997): 52–65.

[51] In cases where nonvoting is equivalent to voting on one side or the other, the government could vote its shares neutrally.

[52] See Theodore J. Angelis, "Investing Public Money in Private Markets: What are the Right Questions?" and Howell E. Jackson, "Regulatory Problems in Privatizing Social Security," both in Arnold, Graetz, and Munnell, eds., *Framing the Social Security Debate.* On activism by state and local pension funds, see Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered," *Columbia Law Review* 93 (May 1993): 795–853.

governmental interference is not just a well designed set of procedures but public support for the notion that the federal government should remain a passive investor. Public support would help to forestall future efforts to modify governmental procedures. Vigorous advocacy of this position by a diverse group of interests is the best way to create such support.

The proponents of the Weaver-Schieber plan are convinced that the consequences of governmental interference in corporate affairs are so serious that they oppose any trust fund investment in the stock market.[53] Their alternative solution is to redirect 5 percentage points of the payroll tax into personal security accounts that individual workers would select and control. The model for this approach is something like 401(k) pension plans or individual retirement accounts (IRAs). Their approach is almost certain to guarantee that the federal government would have no direct influence over investment decisions or corporate governance.

Two controversies surround this approach. First, would it be worth the additional costs to establish, administer, and maintain millions of personal security accounts rather than maintaining a single, centrally-managed trust fund, especially if the principal reason for personal accounts is simply to prevent any possibility of governmental influence with investment decisions and corporate governance? The extra costs would be substantial both for employers, who would direct contributions to the appropriate individual accounts, and for workers, who would have some fraction of their contributions consumed by annual maintenance charges.[54] The first cost would be a special problem for small employers and for those with lots of part-time workers; the second cost would be a special problem for workers at the bottom of the wage distribution and for part-time workers. One measure of the magnitude of the total costs is the enthusiasm of Wall Street firms for individual accounts. On Wall Street these costs are counted as benefits.

The second controversy is whether it makes sense to have millions of workers making separate investment decisions in a public pension program that would continue to be the foundation of retirement security for most Americans. Are all workers capable of making sound investment decisions? What happens if some workers mismanage their investments or fail to annuitize their account balances at retirement and end up dramatically worse off? The proponents of the Weaver-Schieber plan are remarkably sanguine about the ability of workers to manage decisions about investment and annuitization.[55] Empirical studies are less supportive of the notion that individuals make sound investment decisions.[56]

[53] Advisory Council, *Findings and Recommendations*, 126–131.

[54] On the administrative costs for various type of retirement systems, see Olivia S. Mitchell, "Administrative Costs in Public and Private Retirement Systems," NBER Working Paper No. 5734 (1996).

[55] Advisory Council, *Findings and Recommendations*, 114–117.

[56] See James M. Poterba and David A. Wise, "Individual Financial Decisions in Retirement Saving Plans and the Provision of Resources for Retirement," NBER Working Paper No. 5762 (1996); Employee Benefit Research Institute, "Worker Investment Decisions: An Analysis of Large 401(k) Plan

The two controversies together introduce question of fairness across income classes, educational brackets, and the like. Would the poor pay disproportionate administrative costs because their contributions are so small? Does the plan favor well educated workers or workers with particular skills because they are better able to manage their financial affairs? These are important political questions that have not been part of the Social Security debate since the program's inception. They are also the kinds of questions that tend to divide the two parties.

The Gramlich plan occupies the middle ground on investment decisions, annuitization, and the trade-off between individual choice and retirement security. The plan maintains more of the current defined-benefit system and squirrels away in individual accounts only about one-third as much money as the Weaver-Schieber plan (1.6 percent of earnings rather than 5 percent). The proposal also restricts individuals to only a few centrally managed investment options and requires full annuitization of account balances at retirement. The plan clearly comes down more heavily on the side of retirement security than on maximizing individual choice.[57] But it does so by increasing the possibility that a future Congress might abandon passive investing or choose to exercise its voting rights. Under the Gramlich plan, the possibility of government interference is less than it is for the Ball plan, because the new accounts would belong to named individuals; but the protection is not as great as it is in the Weaver-Schieber plan, where the accounts would not be centrally managed at all.[58]

Political Packaging

Most of the alternative schemes for reforming Social Security have been designed by experts on Social Security. Although Congress and the president could choose to adopt one of these prepackaged plans, they are more likely to design their own package. They need to design a plan that can appeal to a diverse coalition of interests in Congress and across the country. Although the

Data," *EBRI Issue Brief Number 176* (August 1996); Diamond, "Macroeconomic Aspects of Social Security Reform."

[57] The philosophical differences are best observed as the proponents of one plan critique another plan. Weaver, Schieber, et al. on the Gramlich plan: "Our first concern is that this option simply contains far more restrictions on workers' choices than we deem necessary or desirable. The option sharply limits workers' investment choices. . . . The plan also forces workers to annuitize their full accumulations at retirement." Gramlich and Twinney on the Weaver-Schieber plan: "The PSA plan permits workers attaining age 62 full access to their accounts that have been accumulated over an entire working career. The government is in effect saying to people that it does not trust them to save for the future when they are younger than 62, so it requires them to hold PSAs. But once these people become 62, they suddenly become wise and responsible, and the government no longer requires them to preserve their assets beyond that date." Advisory Council, *Findings and Recommendations*, 129, 157.

[58] Advisory Council, *Findings and Recommendations*, 129–131; Diamond, "Macroeconomic Aspects of Social Security Reform."

exact mechanism for drafting such a plan has yet to be determined, it is likely that the drafters will be dominated by political experts who are skilled at assembling coalitions for difficult issues.

The menu of options available to policy makers is much greater than the prepackaged plans discussed above, or even all the specific provisions contained in these plans. Policy makers can choose to modify tax rates, benefit formulas, transition schedules, retirement ages, cost-of-living adjustments, tax exemptions, investment options, annuitization rules, and the balance between individual and collective accounts in an extraordinary number of ways and still return Social Security to actuarial balance.[59] Indeed, the amateur policy maker can design quite a few alternative plans just by choosing provisions from a menu of alternatives that the Social Security actuaries prepared for the Advisory Council.[60] For each of eighty-two separate provisions, the actuaries have estimated the impact on Social Security's long-range actuarial balance.[61] Policy makers can ask the actuaries to provide similar estimates for any other provisions that they find appealing.

Rank-and-file legislators will never have the opportunity to vote on all the individual provisions that are part of a final package. A reform package will probably be assembled by a presidential commission, a bipartisan executive-legislative panel, the House Ways and Means Committee, or the Senate Finance Committee; and then legislators will be given the opportunity to approve or reject the final package. Many of the provisions will be individually distasteful, and legislators would never approve them if they had to vote on them one by one. Many legislators would fear electoral retribution for imposing specific costs on citizens that they could easily trace back to legislators' individual roll-call votes. Instead, the package will be framed as an overall plan to rescue Social Security, one that imposes significant costs on lots of people but that does so fairly and in order to achieve a common and popular end.

The job of the drafters is to design a plan that both citizens and legislators perceive to be fair. Public opinion will surely be important to how legislators decide, but the consequential opinions will not be the snap judgments reflected in polls taken about abstract proposals. The opinions that matter will be those that evolve during the period when Congress and the president focus on specific proposals. Citizens' opinions will be shaped by politicians' rhetoric, by the actions of interest groups and the champions of various causes, and by the way the mass media cover the unfolding story. Also relevant is how legislators anticipate that public opinion might evolve after a plan is approved and implemented.[62]

[59] For a discussion of the range of options for dealing with the actuarial imbalance, see Advisory Council, *Reports of the Technical Panels*, 63–92.

[60] Advisory Council, *Findings and Recommendations*, 231–239.

[61] The aim is to pick a set of alternatives that together amount to 2.17 percent of taxable payrolls over the next 75 years (the estimated difference between Social Security's revenues and expenses).

[62] On how legislators anticipate future preferences, see Arnold, *The Logic of Congressional Action.*

The Search for New Options

Given that the greatest impediment to privatization is the need to fund two systems for a while, politicians who favor full or partial privatization are actively searching for ways to reduce the transition costs. One approach is to dedicate all or part of the federal government's looming surpluses to reducing these costs. President Clinton stimulated a search for policy alternatives of this type when he declared in his 1998 State of the Union address that Congress should reserve every penny of the surplus for saving Social Security. His proposal was probably designed to block Republican legislators from adopting a new round of tax cuts and to give all legislators a strong incentive to solve the Social Security problem before dissipating the surplus on their favorite spending programs. No matter what his intent, Clinton's proposal is not neutral toward the various approaches to reform. It advances the cause of privatization—or at least partial privatization—more than it helps those who seek to maintain the current system.

To be sure, budget surpluses could be used to help shore up the current system. But the system is not in desperate need of revenue in the near term. Although Social Security clearly needs to have its revenue and benefit streams recalibrated to forestall long-term problems caused by demographic shifts, an infusion of cash today would only postpone the day of reckoning. A second problem is that Congress needs to devise a mechanism that can effectively reserve the looming surpluses for Social Security. The surpluses will not occur in the operating budget, where deficits continue to be large, but in the unified budget, where annual surpluses in the Social Security account mask annual deficits in the operating accounts. The challenge is to create a mechanism—no smoke and mirrors allowed—that allows surpluses in the unified budget to benefit Social Security when the surpluses are already attributable to surpluses in the Social Security accounts. The challenge is also to prevent future politicians from dismantling the mechanism the next time they need revenue for the operating budget.

The situation is very different for the proponents of partial privatization. They have a desperate need for additional revenue in the near term to reduce the costs of funding two systems. Federal surpluses are just the windfall they need to fund part of the transition. One proponent has already designed a clever mechanism that not only diverts surpluses to this end but also prevents future politicians from redirecting the accrued surpluses to other ends. In March 1998, John Kasich (R-OH), chair of the House Budget Committee, proposed placing most of the surplus into individual retirement accounts for each worker. Individuals could choose how to invest these funds from a list of government-approved options; they could not withdraw funds before retirement.

The Kasich plan has several political advantages. First, it jump-starts privatization by creating and funding individual accounts before Congress and the president settle all the long-term issues about Social Security reform, including

whether to create a new defined-contribution system of individual accounts and what should be the balance between this new system and the current system. Once all these individual accounts are established, however, they provide both a precedent and the infrastructure for investing a portion of workers' payroll taxes in individual accounts. It is stealth privatization. Second, the Kasich plan launches privatization without Congress first having to increase taxes. It avoids the principal stumbling block in other privatization plans. Third, by placing the accrued surpluses in individual accounts, the plan places the money beyond the reach of future politicians who might be tempted to use it for other ends. Finally, it allows Republicans to claim that they have delivered another round of tax cuts, the only difference being that taxpayers cannot spend this particular windfall until retirement. It is a clever political package that makes the transition to partial privatization much easier, especially for those Republicans who consider that raising taxes is heresy.[63]

Senator Daniel Patrick Moynihan (D-NY), the senior Democrat on the Senate Finance Committee, has proposed a different route to partial privatization. Not only does his plan avoid the need for a tax increase, it allows for an immediate tax cut. He proposes reducing the current payroll tax from 12.4 percent to 10.4 percent and allowing workers to use the 2 percent cut to establish voluntary personal savings accounts. Moynihan avoids any transition costs by reducing benefits and by returning Social Security to its pay-as-you-go roots, with just a small contingency reserve. Reversing the planned growth in the trust fund means that the tax rate would eventually drift upwards as the baby-boom generation retires; but the eventual tax increase would be relatively modest, because the benefit cuts between now and then are quite large. The cuts include lowering cost-of-living adjustments by one percentage point a year for current and future retirees, taxing Social Security benefits under the same rules used for private pensions, and continuing to increase the retirement age as life expectancy increases.

The Moynihan plan for partial privatization has much in common with the Gramlich plan. Both plans create a system of individual accounts that would coexist with a slimmed-down version of the current defined-benefit plan. The principal difference between the two plans reflects the authors' occupational roots. Gramlich, the economist, views with alarm the low rate of national savings; he has devised a plan that would increase national savings as quickly as possible by requiring a mandatory contribution of 1.6 percent of taxable wages to an individual investment account. Moynihan, the practicing politician, sees little support among other practicing politicians for forcibly extracting that much additional revenue from workers. So, his individual accounts are to be voluntary, and the combined voluntary contribution and mandatory tax are to

[63] On 1 April 1998, in the first test of the popularity of this proposal, the Senate adopted, 51–49, a nonbinding resolution calling for dedicating the 1998 budget surplus to establishing Social Security personal retirement accounts. The vote revealed deep partisan divisions. Republicans supported the resolution, 49-6; Democrats opposed it, 43–2.

be no larger than the current tax rate. All the pain in Moynihan's plan is in the future—benefit reductions that are phased in gradually and a series of relatively small tax increases that are imposed in the distant future.

The Prospects for Reform

The most important political fact about the Social Security program is that it is the status quo alternative. Do nothing and the program continues. Permanently established in law, Social Security requires neither annual appropriations nor any other type of regular political maintenance. Until Congress and the president agree on how to change the program, payroll taxes keep rolling in and benefit payments keep flowing out, all according to the tax and benefit formulas that were last revised in 1983. To be sure, the current formulas are not sustainable in perpetuity. Annual revenues, supplemented by the trust fund, are adequate to cover all benefit payments for only the next three decades. From a politician's perspective, however, three decades is a very long time.

The one position that virtually everyone who studies Social Security shares is that reforming Social Security expeditiously is preferable to waiting until the problem becomes more severe. No matter how painful some of the remedies seem today, each remedy becomes more expensive as time marches on. If Congress chooses the traditional remedy of raising taxes, it could restore actuarial balance over the next seventy-five years by increasing the payroll tax by 1.3 percentage points each for employees and employers no later than 2002. If it waits another twenty years, it would need to increase the payroll tax by 2 percentage points each. Alternatively, if Congress decides to restore actuarial balance by reducing benefits for new retirees, it would need to reduce benefits by 21 percent beginning in 2002, but by 34 percent beginning in 2022.[64] Delay is even tougher for the proponents of advance funding. Each year the unfunded liability grows larger. Eventually the combined cost of supporting two systems becomes prohibitive. If Congress does nothing until the trust fund is exhausted in 2032, it would require a payroll tax of 8.9 percent each for employees and employers just to pay the next year's promised benefits, plus whatever Congress decides should be set aside for a new advance-funded system.[65]

Those who seek to preserve something like the current system have the advantage that Social Security is a well known and popular program. Although preserving the current system would require difficult decisions about increasing taxes, cutting benefits, or extending the retirement age, these are decisions about which Congress has a great deal of experience. Skeptics sometimes argue that times have changed and that it is no longer possible for Congress to enact these traditional remedies. What the skeptics fail to appreciate is that it was always difficult for legislators to increase payroll taxes and cut benefits. Politi-

[64] Advisory Council, *Reports of the Technical Panels*, 66.
[65] Board of Trustees, *The 1998 Annual Report*, 108.

cians struggled to save the system in 1983. No one wanted to enact the remedies that legislators eventually approved. The argument that times have changed is also undermined by the fact that over the past half-dozen years Congress has approved both tax increases and benefit cuts for the rest of the federal budget. Many people were equally skeptical that Congress could enact those painful provisions.

Those who seek to replace the current defined-benefit system with a defined-contribution system have the tougher row to hoe. They are attempting to sell something new and different, and innovation is a difficult sell in any political system. To be sure, their cause is helped by obvious similarities with such devices as individual retirement accounts, 401(k) plans, and mutual funds. It would have been inconceivable to enact something like the Weaver-Schieber plan or the Kotlikoff-Sachs plan in 1935. The greatest impediment to establishing individual accounts, however, is the need to fund two systems for a while. There is no free lunch here. If citizens want the benefits of an advance-funded system, with or without individual accounts, they must either increase their retirement contributions or accept a reduction in benefits. The closest thing to a free lunch is the unexpected surplus in the federal budget that could be used to fund part of the transition cost.

Although it is encouraging to see that President Clinton featured Social Security reform in his State of the Union address, proposed a White House conference for December 1998, and called for congressional action during 1999, it is impossible to overstate the obstacles to timely reform. The principal obstacle is the lack of a consensus on what Social Security should be. The debate today is not merely about tax rates and benefit levels—the traditional arena for Social Security politics. It is about the basic structure of the system. Altering the structure of any government program is always difficult, but it is especially so for a program that affects virtually everyone in American society.

A second obstacle to timely reform is the lack of an action-forcing crisis. Compromise is easiest when the failure to compromise creates a disaster. Essential to the reform of Social Security in 1983 was the fact that the trust fund was empty and revenues were insufficient to cover all benefit checks. No one wanted to be held accountable for reduced Social Security benefits. Essential to the annual budgetary agreements between Congress and the president is that failure to agree can lead to a government shutdown—a consequence that some politicians found appealing before they tried it several times. Unfortunately, the next action-forcing crisis for Social Security is penciled in for 2032.

Social Security reform today requires that political leaders come together and search for common ground. The search must be bipartisan, not simply because both Democrats and Republicans must join together to enact a reform plan, but because a bipartisan agreement is essential to selling a compromise plan to the American people. The chance that the American people will embrace a reform plan is far greater if Republican and Democratic leaders agree

that the plan is fair than if they resort to partisan bickering as they did when they considered health-care reform.

No one can know today the exact contours of a plan that Republican and Democratic leaders might design months or years from now. What seems certain, however, is that politicians will pay special attention to how costs are imposed. Partial privatization may well be part of a compromise plan, but only if its advocates can devise acceptable ways of funding the transition to advance-funded individual accounts.*

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