WASHINGTON

Progressive Dementia

The president may not get his way on Social Security reform, but one element of the plan will rise again. It shouldn't

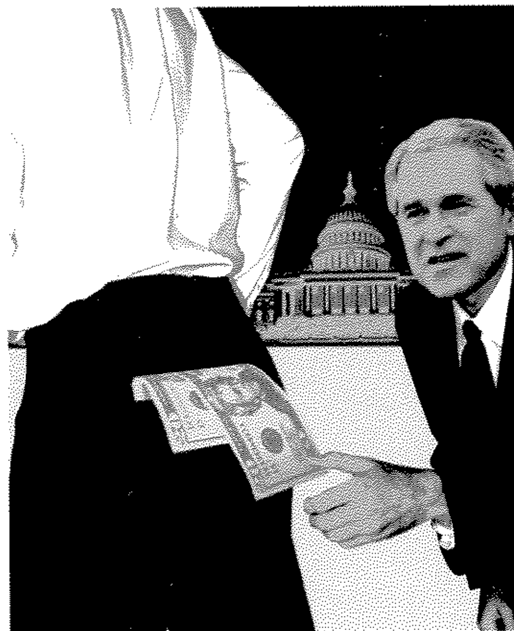
BY JOSEPH E. STIGLITZ

The proposed changes in Social Security for which President Bush has been stubbornly campaigning all year will in all likelihood, despite a chilly public reception, surface as legislation for congressional debate this fall. But the focus of the debate has shifted significantly since the president first brought attention to the subject. And regardless of whether his specific proposals stall or die, one issue now on the table will materialize every time Social Security reform comes up.

When the president introduced the topic of Social Security reform, in his State of the Union speech last winter, his focus was on creating individual Social Security accounts, which would allow participants to divert some money from payroll deductions to private investment. It soon became clear, however, that this would leave the system no more solvent than before. In fact, the federal government would have to borrow trillions of dollars to make up for the lost revenue. This was a problem, given that concern about solvency was the ostensible reason for proposing changes in the first place.

In truth, it is not at all clear that Social Security is in deep trouble; as with many things in economics, one's assessment depends on what projections one uses. But if it is, "trouble" simply means that its projected expenditures exceed its projected revenues. Only two solutions exist: reduce expenditures or increase revenues. Faced with criticism that his original proposal did neither, the president floated another one in a speech last April.

The art of politics is to design a solution that feels painless to all. (Or, as the seventeenth-century French finance minister Jean Baptiste Colbert observed, "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.") The president's version is called "progressive indexation." This proposed path to solvency has just enough complexity and fine print to make it sound serious—and to make a full analysis of its consequences difficult.



ILLUSTRATIONS BY JOHN RITTER

Progressive indexation would change the way Social Security benefits are computed. Benefits are now based on recipients' contributions, but they are indexed to the general level of wages, and rise over time. As the country becomes more prosperous, and wages increase, retirees get more money. Under the president's proposal benefits for most Americans would increasingly be indexed to prices rather than to wages; the higher a worker's income, the greater the proportion pegged to prices. Because prices increase more slowly than wages (sometimes much more slowly), this would mean an enormous reduction in benefits—and enormous savings for the Social Security system. At the same time, the poorest Americans—those with incomes below $25,000—would still receive benefits indexed to wages. In championing a change that would penalize the better-off while protecting the poor, the president managed to cast himself as something of a latter-day Robin Hood.

The first question to ask is, Does progressive indexation really address Social Security's potential problems? In fact it would be hard to think of a worse way to address them.

To begin with, we don't actually know how serious the shortfall is. To assess the system's solvency we must make economic projections far into the future. As the chairman of the president's Council of Economic Advisers during the 1990s, I had to make projections about where the economy was going to be one, two, or three years ahead; frankly, I often found myself facing a cloudy crystal ball. Forecasting a few years out is hard enough; forecasting seventy-five years out is essentially impossible. Slight changes in life expectancy, immigration, wage growth, and interest rates could have large effects on the solvency of the system.

For instance, if immigration and productivity continue at their current rates, and if real wages move in tandem with productivity, as they have done historically, the Social Security system as it now stands will remain solvent. (It is perhaps not surprising that when President Bush sold Congress on his tax cuts, he did so by using growth projections far more optimistic than the ones he is now using for Social Security. The president is proving to be more dismal, one might say, than most economists.)

Of course, no one can say for sure that a quarter century or a half century hence, Social Security won't be in the bad shape the president fears; and a case can be made for doing something now to forestall problems later. But what we do should be designed to meet needs as they develop.

Progressive indexation is not well designed to address future uncertainties. It would improve Social Security's fiscal solvency most when real wages were increasing rapidly. But under those circumstances the system would in all likelihood remain fully solvent without interference. When real wages were stagnating, progressive indexation would do nothing to improve Social Security's condition. But those are precisely the circumstances under which the system would face the greatest danger of insolvency.

In short, progressive indexation is a mechanism that would "work" when we didn't need it and wouldn't work when we needed it most.

Granted, there is a middle ground where progressive indexation could in theory have some modest effect. But here we need to revisit the issue of individual accounts, because combining them with progressive indexation would almost certainly drain money out of the system, exacerbating the solvency problem or even undermining Social Security altogether.

Some background: The president has argued that individuals would be able to get a better return on their retirement accounts than the government does. On this he is simply wrong: no private firm can compete with the Social Security Administration in the efficiency with which it has administered its funds. In other countries that have privatized their social-welfare systems, benefits have fallen—in Britain, according to one estimate, by as much as 40 percent—as year after year transaction costs eat up what workers have put away.

Social Security does *seem* to give lower returns than private investment, for four reasons. First, it is safer. Second, there is a hidden tax in the system for middle- and upper-income workers: their benefits are reduced to help ensure that the poorest Americans do not retire in poverty. Third, most of the standard calculations of Social Security's rate of return do not take into account the value of survivors' and disability benefits. Because more than a third of those who currently collect benefits are not retired workers (among them nearly 12 million spouses and children of retired, disabled, or deceased workers, and 6 million disabled workers), ignoring these benefits significantly lowers estimates of returns. And fourth, some of the contributions of today's workers are used to finance the retirement of previous generations—this is the nature of a partial pay-as-you-go system.

Already Social Security is being portrayed as a bad deal, although it is not, particularly when one takes into account that no *private* investment can, for instance, insure one against inflation. (Only recently has the government provided inflation-protected securities, and the returns on Social Security contributions do not look unfavorable in comparison to the returns on these securities.) If it is a bad deal for some, that is not because it is inefficient but because it is redistributive. Under progressive indexation the benefits per dollar contribution of all but the poorest would be cut, thus—to follow the logic—making Social Security an even worse deal for all but the poorest Americans. One calculation has shown that by 2045 the rate of return for a worker earning $58,400 would be cut by more than 50 percent.

If progressive indexation and individual accounts both came to pass, middle- and upper-income Americans would look ahead at the likely consequences and vote with their feet. That is, they would divert as much money as possible out of Social Security and into their individual accounts. This might be heralded as a vote of confidence in the individual-account idea—and it would generate billions of dollars in commissions for managers of private assets. But it would erode, not enhance, the solvency of the Social Security system as a whole. Simply put, those who once contributed the most to the system would drop out to whatever extent they could.

Of course, a system of progressive indexation without individual accounts wouldn't have this outflow problem (though one can't imagine the administration's giving up private accounts). But even that arrangement would raise a serious question of equity.

Since the current system of wage indexation means that benefits increase with average wage levels, which normally increase far faster than prices, it allows workers to benefit from the productivity gains that usually drive wage increases. These productivity gains are usually not the result of anything individual workers do, but follow from innovation and investment.

A simple philosophical question: Should those who are fortunate enough to have high wages today, because productivity in general has increased, share some of their good fortune with workers of previous generations? The answer has fundamental implications for the nature of our society, particularly if wages increase rapidly. Assume, for instance, that real wages (taking inflation into account) increase by three percent annually, which means they double roughly every twenty years: the average wage of a forty-year-old worker will be approximately *four* times what an eighty-year-old earned back when he was forty. And under a system of individual accounts, or of price indexing, even if the eighty-year-old saved so avidly that his retirement income was the same as his average working income (which is seldom the case), he would have a quarter of the income of the forty-year-old worker. The current Social Security system goes a little way toward rectifying such inequalities. If our economy sees a three percent annual growth in real wages, our eighty-year-old retiree will have a share in the bounty: his Social Security payments will be four times as high as they would have been had the president's progressive-indexation plan been in place.

Under Bush's proposal there would be an enormous income gap across generations, on top of the already increasing income gaps that separate various groups in our society—the skilled and the unskilled, college graduates and high school dropouts. This gap would exist not because the aged failed to work hard while they worked, or even to save, but because they were born when they were born.

Those who advocate a switch to progressive indexation need to explain not only how it can possibly work, despite theory and evidence to the contrary, but also why the price of a more divided society is worth paying even if it does. ▲

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