The More It Changes, the More It Stays the Same?: Automatic Indexing and Current Policy

Daniel Shaviro

NYU School of Law, daniel.shaviro@nyu.edu

Follow this and additional works at: http://lsr.nellco.org/nyu_lewp

Part of the Law and Economics Commons, Law and Politics Commons, Legislation Commons, Public Law and Legal Theory Commons, Taxation-Federal Commons, and the Tax Law Commons

Recommended Citation

http://lsr.nellco.org/nyu_lewp/418

This Article is brought to you for free and open access by the New York University School of Law at NELLCO Legal Scholarship Repository. It has been accepted for inclusion in New York University Law and Economics Working Papers by an authorized administrator of NELLCO Legal Scholarship Repository. For more information, please contact tracythompson@nellco.org.
I. INTRODUCTION

The ancient Greek philosopher Heraclitus famously remarked that you cannot step into the same river twice, to which a disciple supposedly replied that you cannot do so even once.\(^1\) Both remarks may shed light on the problem of specifying how legislation should apply over a period of years, in relation to the aim of keeping what I will call “current policy” constant as time moves forward. Heraclitus reminds us of the difficulty of truly being in the same place at different times, if everything is continually changing around oneself. The disciple could be viewed as casting doubt on the notion that there is such a thing as a well-defined place, even the first time around.\(^2\)

Despite these warnings from the ancient world, two simple ideas about policy across time may initially seem uncontroversial. The first is that, if (and insofar as) two different years are relevantly the same, the policies that apply to them should be the same. The second is that, in order for the policies applying in different years to be the same, their nominal terms may need to differ.

---

\(^{1}\) The latter is from Kierkegaard, epilogue to Fear and Trembling.

\(^{2}\) Kierkegaard in relating this anecdote, instead views the disciple’s maxim as converting the Heraclitean thesis of constant flux into the “Eleatic thesis that denies motion.” Cite to Kierkegaard. The “Eleatic” reference is to Zeno of Elea, who famously “proved” that motion is impossible – for example, because to get anywhere one must first go halfway, and before that halfway to there, and so on ad infinitum.
The classic, and seemingly no-brainer, illustration of both ideas is indexing the dollar amounts in particular statutes for inflation. Annual inflation indexing has been in place since 1981 for the marginal rate brackets in the U.S. federal income tax, and since 1972 for U.S. Social Security benefits. Obviously, or at least apparently obviously, it results in keeping income tax and Social Security policy substantively the same across time. Absent inflation indexing, Congress would frequently have to amend the law – changing nominal dollar amounts in the statutes – in order to keep the actual policy the same.

We will see, however, that keeping current policy the same is more complicated and perplexing than it may initially seem. Indeed, a closer look even just at inflation indexing in the income tax and Social Security reveals broader issues, pertaining to both motivation and implementation. The dissonance only widens when one turns to other actual or possible types of automatic indexing in the income tax and Social Security.

To develop these points, section II discusses policy continuity over time. Section III addresses automatic indexing in the income tax, whether for inflation or otherwise. Section IV discusses actual and possible indexing of various kinds in Social Security. Section V offers a brief conclusion.

II. POLICY CONTINUITY OVER TIME

A. Current-Year Policy and Constant Meta-Policy

When Congress passes a law, it does not necessarily have a broader, fully specified policy in mind. Even a specific legislator who votes in favor of the legislation may intend little more than to signal public support for something that he may know little about, and care about even less. Enactment by a bicameral majority adds all of the conundrums associated with
collective choice. And if one wants to discern the policy behind multiple pieces of legislation, enacted at different times, then one must further consider how they all relate to each other.

Nonetheless, if we think of law as having normative content, rather than as just a bunch of words chosen by happenstance under arbitrary rules of the game, then there is reason to think in terms of the “policy” that a given law, set of laws, or all the laws together should be deemed to express. Even if we know nothing about actual policymakers’ past intent or likely future behavior, this may relate to how one might reasonably rationalize the rules that we observe. What broader aims and views, one might ask, could the laws on the books plausibly be viewed as advancing?3

Accepting the concept of underlying policy for any one year raises the question of how such policy should apply to other years. Suppose initially that two distinct years are exactly the same, in all respects that are relevant to the policymaker. The one thing that can’t be the same – particular individuals’ ages as time goes by – is not itself directly relevant if one values all individuals equally. If everything relevant is the same, then the right policies are also the same. And even if, as is inevitable, something relevant has changed, then presumably the change in policy should be commensurate to the change in circumstances. This, however, involves positing an underlying meta-policy, under which, at least in a consequentialist framework, the rationale for current-year policy reflects a more general relationship between relevant circumstances and desired rules.

To illustrate, suppose one views tax levels and the income tax rate structure as properly reflecting a tradeoff between efficiency and distributional concerns. As the relevant considerations have been formalized in the optimal income tax (OIT) literature, founded by

---

3 However, the issue here is not statutory interpretation of existing law by a court. Rather, I am addressing the question of what new legislative acts (or decisions not to act) might be implied by support for the broad policy that one attributed to past legislative acts.
Mirrlees (1971), the three key empirical inputs to setting tax levels and rates, under a given social welfare function, pertain to labor supply elasticity, the rate of declining marginal utility in people’s utility functions, and the distribution of ability in the population (see Shaviro 2014). Changes to any of these inputs would support changing the applicable tax levels and/or rates, but at a more general level the underlying OIT-informed “policy” would have remained the same.

In a real world setting, while the relevant considerations are unlikely to be so specifiable or conceptually tidy, it is similarly plausible that a constant metric for making judgments would require that, under a constant meta-policy, the details of currently applicable policy should change with relevant circumstances. However, for fiscal rules, or those that involve taxes and spending, there are two distinct reasons why one may be unable to deduce how currently applicable policy should adapt when circumstances change, in order to stay the same at the meta-level.

First, suppose that, as appears to be the case for the United States today (see, e.g., Auerbach and Gale 2014), a given set of policies would yield a long-term fiscal imbalance between revenues and outlays, making the set of policies eventually unsustainable. This suggests that the actual long-term policy being followed, in the sense of what is foreseeably likely to happen, includes creating the eventual need for a significant course correction. Given that the creation of such a need truly is a part of current policy, any account of such policy which does not specify an adjustment mechanism is incomplete. Yet nothing about current policy permits one to identify the adjustment mechanism, which instead may vary with people’s political preferences even if they are able to agree both about current-year policy and about what the laws should currently say about future years.
Second, even insofar as the laws on the books are indefinitely sustainable, it often is the case that multiple meta-policies can plausibly be inferred from them. Even policymakers who viewed themselves as fully agreeing about current policy may not have considered how they would want to respond to particular changes. Upon such consideration, they might find that they disagreed. Accordingly, agreement about current-year policy may mask underlying disagreement about meta-policy, making it hard to say how changing circumstances should affect the applicable rules under constant or current policy.

B. Setting Policy for the Future

While current policy need not imply a particular meta-policy that expresses how current-year rules should change with the prevailing circumstances, suppose that a given policymaker does indeed have at least aspects of her preferred meta-policy firmly in mind. Then she can try to specify in advance, through the law on the books, how current-year policy should change automatically (i.e., without requiring new legislation), based on particular empirical metrics that get computed on an ongoing basis. Let’s call this indexing, with inflation indexing of income tax brackets and Social Security benefits being just one example.

Why wouldn’t one fully specify how current policy should change along with specified circumstances? Obviously, doing so can be unduly costly. One could think of it as an incomplete contracting problem among legislators, where the grounds for not going through the full exercise include not only scarce time, imagination, and other costly resources, but also the vagaries of coalition formation. Agreeing to disagree about things that don’t immediately matter may make it easier to develop a majority consensus.

Suppose, however, that one knows the meta-policy one prefers, and has the power to get it enacted through an indexing rule of some kind. Then it is hard to see why one wouldn’t want
to implement it, thereby giving one’s long-term preferences the benefits of legislative inertia and also, perhaps, building them into widely accepted intuitive baselines. In current politics, for example, slowing Social Security benefits’ projected rate of real increase\(^4\) is commonly classified as “cutting Social Security,” offering an important rhetorical thumb on the scales in favor of those who support the associated meta-policy.

Does indexing unfairly or undesirably reduce future decision-makers’ discretion? Surely not, at least as a general matter, given that they still remain free to do whatever they like. Lack of indexing equally implies a default set of rules for future years. Moreover, not indexing the rules to change under a particular metric is equivalent to setting the index for that metric at zero, and it is not clear why zero should be considered neutral or the most natural default.

For these reasons, I view the general normative case for automatic indexing as simply too easy to be interesting, in instances where one likes the meta-policy that it would put into the baseline. But given the under-specification of current policy, in light of the long-term fiscal imbalance and such policy’s potential consistency with multiple meta-policies, the assessment of particular indexing proposals requires debating the actual merits, in terms that a “current policy” benchmark may fail to illuminate greatly.

If the issues of real interest and difficulty turn on the merits of particular policies, rather than on whether it is appropriate in principle to have laws change automatically under pre-specified metrics, what can one usefully say of a more general nature? An obvious topic of interest is political economy effects. These, however, are in practice quite variable and context-dependent. Accordingly, in the rest of this chapter, rather than seeking to reach general conclusions about when and how one should index, I will offer a close look at two particular

---

\(^4\) As I discuss below, Social Security benefits are indexed not only annually for inflation, but also upfront for growth in wage levels during one’s working career (up to age 60). In addition, since Social Security provides a fixed real life annuity, one could think of it as providing automatic benefit increases as life expectancies grow.
institutional settings – the U.S. federal income tax and Social Security – in which automatic indexation can take on multiple guises.

III. INDEXING THE INCOME TAX RATE BRACKETS

A. Inflation Indexing

Congress in 1981 adopted automatic annual inflation indexing for income tax rate brackets. As an example of how this works, in 2014, for joint filers, the 15 percent bracket started at $18,150 of income and ended at $73,800. For 2015, however, these amounts were adjusted to $18,450 and $74,900, reflecting an annual inflation rate below 2 percent plus the effects of automatic rounding.\(^5\)

While the effect of indexing rate brackets may seem trivial in an adjacent-years comparison when inflation is low, even with continually low (but non-zero) inflation it can make a major difference across longer time periods. For example, inflation of just 2 percent a year for 10 years would require one’s income to increase by 22 percent over that period, just to stay the same in purchasing power terms. That extra nominal income, however, could move into higher rate brackets that were nominally fixed.\(^6\) This well-known phenomenon is called “bracket creep.”

*Why do we have automatic inflation indexing?* – “It’s hard to make predictions,” Yogi Berra once said, “especially about the future.” Automatic inflation indexing, however, would almost appear to invite a false prediction about the past. There are at least two seemingly

---

\(^5\) While for now I simply assume that there is such a thing as “the” inflation rate, despite varying price level changes as between commodities and technological changes in available products, in section III below, relating to Social Security, I address the significance of these problems.

\(^6\) Suppose, for example, that a given taxpayer had taxable income of exactly $18,450 in 2015, and that this amount increased by 2 percent annually, in exact lockstep with the inflation rate. In 2025, she would earn $22,480. If rate brackets remained nominally fixed, in 2025 she would face a 15 percent marginal rate with respect to $4,040 of this income, raising her tax bill by $202 relative to the case where there was inflation indexing.
plausible grounds – albeit, somewhat contradicting each other – for concluding that surely the U.S. Congress would not allow income tax rate brackets to increase automatically by reason of inflation.

The first is Leviathan theory, which views government as a “monolithic ‘Leviathan’ that attempts, with the single-mindedness of a ruthless monopolist, to maximize its revenues” (Shaviro 1997, 89). Nobel Economist James M. Buchanan and colleagues generated from this model the by now self-evidently false prediction (seemingly plausible in the 1970s) that governments will systematically favor imposing unexpected inflation, as a way of devaluing existing public debt (Brennan and Buchanan 1980, 15-16, 28-30). They also expected Leviathan to welcome the opportunity to impose automatic tax increases through bracket creep (Buchanan and Wagner 1977, 142 n. 18).7

Second, perhaps more plausibly today, suppose one expects politicians to be very interested in credit-claiming, so they can impress inattentive voters. Then the last thing they should want is mechanisms under which pro-taxpayer changes to the law on the books, such as through rate bracket indexing, will take place automatically. Surely it would be better, from the incumbents’ standpoint, to act like actual U.S. Congresses in the 1970s, which enacted repeated tax cuts that bracket creep helped to finance. Thus, Congress should seemingly have wanted to keep on getting credit for cutting taxes repeatedly, even as real tax burdens were going up. Inflation indexing impedes credit-claiming by making the relief from bracket creep automatic.

In retrospect, perhaps the enactment of inflation indexing depended fortuitously on how the 1970s tax revolt, partly triggered by bracket creep in an era of high inflation, happened to play out. Ronald Reagan made rate bracket indexing a key part of his 1980 campaign platform,

---

7 From today’s perspective, a “democracy in deficit” model is hard to square with the political strength of post-2008 demands, in multiple Western countries for fiscal austerity and for prioritizing deficit reduction over addressing persistent unemployment.
and his sustained political success then helped lock it into place. Path dependence aside, however, while it is easy to think of plausible explanations for the largely unchallenged retention of inflation indexing for the income tax brackets since 1981, it is hard to be confident that these explanations are actually correct. For example:

-“Automatic indexing is good for incumbents, despite the loss of credit-claiming opportunities.” – Without indexing, offsetting bracket creep would require the periodic enactment of new legislation. This, in turn, might be impeded by gridlock and pervasive political disputes between the parties. If this meant that sometimes nothing would be done to prevent bracket creep, voters might blame incumbents generally for the rising tax burdens that resulted, even without understanding the causation. So indexing might be a good insurance policy for incumbents generally, preventing this from happening.

While this sounds plausible, such reasonable judgments do not always prevail politically. Consider repeated showdowns in recent years over the federal debt ceiling, risking default and consequent disruption of the U.S. and global economies, for which conceivably all incumbents would tend to be blamed. The Republican Congressional leadership has nonetheless so far refused to eliminate the debt ceiling, or to allow it to increase automatically and entirely without drama. This, in turn, presumably reflects the important tactical point that, if blame might be shared asymmetrically, particular political actors may benefit (or believe they would benefit) from playing chicken games that risk inflicting blame on all incumbents for the harm that results if they do not agree in time. So one might need some different explanation of why the political risk of imposing inflationary bracket creep has been permanently solved, while other risk points remain on the table.
--“Since bracket creep allows taxes to rise automatically, those on the anti-tax side of the political spectrum will strongly fight for the retention of indexing.” – This statement suggests that, in the U.S. political setting, once indexing is in place, only a thoroughgoing rout of the Republicans could lead to its elimination, and there has not been one since 1981. Once again, while this is plausible, there are objections. For example, Democrats have not pushed to eliminate indexing. Now, perhaps they shouldn’t, given that its impact would mainly be felt among voters who are currently in lower rate brackets, and thus could be pushed by bracket creep into higher ones. Yet if this consideration is important, mightn’t it be expected to soften Republicans’ opposition to repealing indexing, relative to other ways of increasing taxes?

A further point is that bracket creep, even if unwelcome to particular political actors, could also potentially serve their interests as a device for agenda control. Thus, consider the Republican-controlled enactment in 2001 of large tax cuts that would expire automatically in 2010 unless Congress acted to extend them. While enactment of the automatic sunsets responded to the existence of Senate budget rules that would have required supermajority support for permanent tax cuts, the politics soon changed. By 2010, as “debate rage[d] in Washington over the [looming expiration of] the Bush tax cuts,” the architects of the 2001 legislation crowed publicly about their success in “lay[ing] the trap” and thereby putting Democrats “definitely on the defensive” (Kurtz 2010).

Might there be scenarios in which bracket creep played out the same way? For example, might Republicans in some scenarios welcome its creating an ongoing need for “tax cuts” just to keep things in place? Maybe so, but that would require inflation to be a lot higher than it is today. So perhaps the most compelling reason why inflation indexing of the rate brackets
remains so politically uncontroversial at present is that, with low inflation, it just doesn’t matter enough to be worth fighting over.\(^8\)

*A recent expansion of indexing* – Between 1986 and 2012, an important (though not unique) exception to the practice of indexing dollar amounts in the Internal Revenue Code pertained to the alternative minimum tax (AMT). In general, the AMT employs a broader income measure than the regular tax, but has lower rates and a larger exemption amount. Individuals pay whichever is greater, their regular tax or AMT liability. The fact that AMT exemption amounts were not indexed to inflation caused its reach to keep growing over time, creating political problems to which Congress responded sporadically, such as by enacting a one-time increase in 1993, followed by a succession of short-term “patches” in the early 2000s. Finally in 2012, however, Congress not only enacted a permanent increase in the AMT exemption amounts, but indexed them to inflation, thus solving the issue more permanently.

While the end result of this process helps to show how indexing can appeal on both sides of the aisle, as a way of permanently eliminating the predictable consequences of using nominally fixed dollar amounts, it certainly took Congress a long time to get there under the AMT. In this regard, growing particularized dislike on both sides of the aisle for having to deal repeatedly with the AMT may have played a crucial role in yielding the eventual outcome.

Not all dollar amounts in the U.S. federal income tax are indexed to inflation, even where the predictable result is automatic tax increases. At least in some cases, this may be deliberate. An example is the aggregate $1.1 million ceiling on home mortgage indebtedness that can trigger deductible personal interest expense. This amount is slowly declining, in real terms, since it is not indexed to inflation. I know of no recent proposal to change this – perhaps reflecting that the

\(^8\) Indeed, as we will see in section IV, in the case of Social Security, where the effects given to inflation matter a lot due to the use of more long-term budget forecasts, at least the question of how to measure inflation for indexing purposes evidently *is* considered worth fighting over.
home mortgage interest deduction is normatively controversial among policymakers, who may welcome the opportunity to scale down the ceiling in a “boil the frog slowly” scenario. The acid test will come when the nominally fixed ceiling becomes a significant constraint for more people, at which point Congress may face greater pressure than it does today to increase the ceiling above $1.1 million, and/or index it for subsequent inflation.

*Is indexing the rate brackets for inflation good policy?* – While I myself favor the retention of inflation indexing for the rate brackets, the case is perhaps more contingent than is commonly recognized. It is true that inflation indexing prevents the occurrence of automatic, and to a degree, stealth tax increases based on seemingly anomalous factors (i.e., the inflation rate, along with one’s proximity to adjoining higher tax brackets). One might be willing to tolerate this, however, if one believed that the direction of change was generally desirable, and that achieving it more directly and overtly was difficult. Examples of beliefs that might lead one to favor the repeal of inflation indexing include the following:

--Support for raising marginal tax rates on the lower range of the income distribution – for example, so that the rate structure will be flatter overall, but by leveling up rather than down.

--Support for automatic revenue-raising of any kind, to counter budgetary concern about long-term fiscal sustainability. Here the existence of a long-term fiscal imbalance suggests that one is in a sense privileging the current rate brackets (considered in real terms), relative to other parameters that might need to change, by indexing them automatically to inflation. This complicates the merits, since one might also dislike alternative adjustments to address the imbalance.

--Support for making policymakers more inflation-averse, if the prospect of triggering bracket creep would deter them from tolerating it.
--Support for making policymakers less inflation-averse, if the prospect of raising taxes automatically would encourage them to tolerate it.

B. Other Automatic Indexing Possibilities

Even just for income tax brackets, the possibilities for automatic adjustment based on how empirical measures change over time go well beyond inflation indexing. Fully evaluating them would raise issues of policy substance and political economy that lie beyond the scope of a short chapter such as this one. They do, however, help to show the ambiguity of “current policy.”

*Indexing rate brackets for real economic growth* – Perhaps the closest analogue to inflation indexing of the income tax rate brackets would be also indexing them to real economic growth. Over time, rising individual incomes, by reason of per capital wage and GDP growth, tend to push people into higher tax brackets. Over many decades, the effect of this phenomenon, known as “real bracket creep” to distinguish it from the inflationary kind, can be significant. For example, between 2015 and 2040 the Congressional Budget Office (2015, 69) predicts that real bracket creep will cause the share of ordinary income that is subject to the top 39.6 percent marginal rate to rise from 12 percent to 16 percent – a 33 percent increase in its relative frequency. Alan Auerbach and William Gale (2014, 15-16) estimate that real bracket creep, if permitted to occur, would cause total federal tax revenues to rise from 17.9 percent of GDP in 2024 to 21.6 percent in 2089.

For a given individual, the fact that real income growth causes one’s tax liability to increase, not just in real terms but also as a percentage of one’s income, can be called “real bracket creep” if one likes. However, far from being inconsistent with current policy, it actually
epitomizes the expected result of having progressive rates. By contrast, bracket creep in the aggregate could potentially be viewed as changing current policy, in either of two ways.

First, one might believe that current revenue levels, expressed as a percentage of GDP, are an important component of actual current policy. This is the stance that Auerbach and Gale take. They are concerned with assessing the long-term fiscal situation or budgetary status of the U.S. government, in connection with the question of whether government spending is on a path to exceed revenues by so much that we would face, at some point (and if so, when) an unsupportably high ratio of public debt to GDP. They therefore use a current policy baseline to compute the long-term fiscal gap relative to GDP, while also asking how particular “changes” in policy would affect the measure. Under “current policy,” in their view – as distinct from “current law” – policymakers should be expected to prevent real bracket creep from significantly increasing revenues relative to GDP. Retaining current law indefinitely would therefore, in this respect (they argue), be a policy change.

In short, they argue for broadening the frame in determining what “current policy” means. Over the long run, policymakers do not merely intend that particular marginal rates apply at particular income levels, but also that the “size of government,” as very crudely measured from annual outlays as a percentage of GDP, stay about the same. Thus, policymakers would be expected to change the tax law, rather than keep it the same, unless they decided at some point in the future to change tax policy, rather than keeping it the same.

Suppose one optimistically thought that what current policymakers actually want to do is equate the marginal cost of government spending to the marginal benefit. Then, if at the margin government spending is a superior good (i.e., with an income elasticity of demand above one),

---

9 On just how a bad measure “government spending” is of the size of government, see Shaviro 2007, 15-52. I have no reason to think that Auerbach and Gale would disagree with my arguments; they are offering a view of how policymakers actually do think about size of government issues.
current policy might plausibly be defined as consistent with rising taxes relative to GDP. Of course, in that scenario it would not necessarily follow that real bracket creep was getting desired revenues to just the desired level, rather than being too high or still too low. But the ultimate point here, as Auerbach and Gale would surely agree, is that defining current policy over the long run is inherently a tricky exercise.

I turn now to the second ground on which real bracket creep could be viewed as inconsistent with current policy. Arguably, the current marginal tax rate structure has an intended relationship to overall income distribution. Thus, suppose that the highest rate brackets (33 percent and above) are not intended to apply far below the 90th percentile or so. Real bracket creep would gradually transform the U.S. system into a relatively high-rate, flat-rate system for more people. And again, whether this would be good or bad, it may be viewed as inconsistent with actual current policy.

If one believes that preventing real bracket creep would be good policy, there is an argument for building it into the law through express indexing of some kind. After all, this would improve (by one’s lights) the set of policies on the books that were entrenched by inertia. However, a separate argument might be based on the view that Congress is likely to offset real bracket creep even if there is no automatic adjustment. Here the rationale for doing it through automatic indexing would simply be to make the adjustment process smoother and more predictable.

---

10 This would further depend, however, on the extent to which policymakers believed that they needed to fund projected spending through the tax system.

11 For example, the indexing rule could use a formula of some kind that was based on the adjustments needed to keep revenues constant as a percentage of GDP and/or on maintaining the income percentiles at which particular rate brackets kicked in. One conceivably might want to distinguish in some way between the revenue effects of real bracket creep on the one hand, and distributional changes (such as to high-end inequality) on the other hand.
The “Rising Tide Tax System” – In 2006, economists Leonard Burman, Robert Shiller, Gregory Leiserson and Jeffrey Rohaly (“Burman et al”) proposed that the U.S. federal income tax system be indexed to respond automatically to changes in inequality. Under what they call the “Rising Tide Tax System,” tax rates and credits would automatically change to increase progressivity when inequality rose (as measured statistically by a specified method, relative to a benchmark year), and to reduce progressivity when it declined.

If “normal” inequality was benchmarked to a year when it was lower than in the year of enactment, the Rising Tide system would deliver a one-time shift towards greater tax progressivity. Thereafter, however, since the system would apply symmetrically to inequality changes in either direction, it would have no net expected effect on tax progressivity unless one believes – as many do – that pre-tax inequality is likely to continue increasing, as it generally has for more than thirty years.

Burman et al (2006) argue that one need not systematically favor greater progressivity, relative to the system’s starting point, in order to support the automatic indexing feature. So long as one agrees that inequality has rising marginal social costs, the automatic indexing feature could be viewed as having insurance value. In addition, they argue that it would help build political support for the adoption of pro-growth policies since, “[i]f the economy grows, people at every income stratum would be guaranteed of sharing a portion of the gains, even if the pre-tax gains are highly concentrated” (17). However, a separate rationale could involve supporting greater progressivity and believing that inequality is likely to continue increasing. One also might believe that ordinary political processes tend to deliver anti-insurance with respect to rising inequality, since the rich may grow ever harder to tax as their economic and political power increases.
Tax smoothing – Under the approach to long-term budget policy known as tax smoothing, tax rates should generally be the same for all years, and should be set so as to produce long-term budgetary balance (Barro 1979). Whenever estimates regarding long-term spending levels change, tax rates should promptly be adjusted accordingly. Failing to do so, when on a long-term basis they are either too low or too high, has two disadvantages. “First, [it] … may induce taxpayers to shift taxable transactions from high-tax to low-tax years …. Second, even if economic activity cannot shift between years, the application of higher rates to some years and lower rates to other years tends to increase economic distortion …. [because] the deadweight loss from a tax generally rises more than proportionately with the rate of the tax” (Shaviro 2009, 1338-39).

While normally considered just a general policy guide, tax smoothing could in principle be implemented through indexing rules that responded automatically to changing long-term budget forecasts.12 Rationales might include increasing interim certainty regarding likely future rates and addressing legislative incentives to fail to finance new initiatives. Suppose, for example, that President George W. Bush had faced a budgetary rule that, in the absence of legislation expressly suspending it, would have required immediate tax increases to supply long-term financing for the Medicare prescription drug benefit. Even if a provision calling off the automatic rate increase could easily have been added to the underlying legislation, the need to do this might have heightened the visibility of issues of long-term cost.

Obviously, when there is a large fiscal imbalance, tax smoothing as a means of addressing it is likely to be objectionable to those who prefer to address it through other means, such as by reducing outlays and/or tax expenditures. However, if there were no such imbalance, 

12 When long-term fiscal projections worsen due to a down business cycle, an automatic tax smoothing rule might be undesirably procyclical. However, such a rule could in principle be adjusted to address this problem.
proponents of smaller government might have reason to favor it, on the ground that it would require new spending proposals to be financed. Annual balanced budget requirements are at times similarly rationalized, although they may use spending-side rather than tax-side automatic adjustments. However, their reliance on a noneconomic cash flow measure of government finance, rather than on long-term fiscal sustainability, makes them a very different sort of instrument in practice.

IV. SOCIAL SECURITY INDEXING

A. The Distinctive Social Security Context

Social Security is a distinctive arena for evaluating both indexing and the meaning of “current policy,” due to three of its key features:

1) The budgetary estimates that play a central role in tracking its performance under the self-financing convention go 75 years into the future – as compared to the just 10-year period that Congress commonly uses elsewhere under its budget rules and conventions. In addition, the effect that a given proposal would have on seniors’ monthly benefit checks is likely to be highly politically salient, even if the impact would be deferred for some years. Thus, small annual differences, such as in how inflation is computed, can become far more politically consequential for Social Security than in the broader budgetary setting – and all the more so if they can be called “benefit cuts.”

2) Social Security is supposed to be self-financing, and thus uses trust fund accounting to track the long-term relationship between revenues and outlays that are credited to the system. This causes the point that “true” current policy cannot fail to address a fiscal imbalance to apply with especial force here, at least so long as the self-financing convention is generally accepted.
In effect, current Social Security policy has both a specified component, consisting of how each of its rules would apply over the long term under present law, and an unspecified component, involving the apparent commitment to maintain long-term fiscal balance within its formal contours.

So long as the self-financing principle is accepted, Social Security may eventually require some combination of tax increases and benefit cuts. Which side of the ledger to emphasize tends to divide the left and right in U.S. politics. In addition, there is an odd tension between (a) the apparent “Washington consensus,” running from the moderate left to the right, that some degree of Social Security benefit reduction is necessary, and (b) the also widespread consensus that Americans’ retirement saving is too low (see Shaviro 2015). All else equal, reducing people’s Social Security benefits reduces their retirement saving. An increase in current benefits, at least for those most in need of greater retirement saving, could in principle be financed through some other set of changes, either inside or outside the Social Security system.

3) For better or worse – and there are arguments on both sides – the link between individuals’ taxes and benefits is anything but straightforward. Monthly retirement benefits, which are fixed for life via inflation indexing, depend on the operation of a complex formula based on one’s average monthly earnings, counting only earnings up to the system’s annual payroll tax ceiling, and with reference only to one’s 35 highest-earning years. For this purpose, the relevant earnings for any year before one reached age 60 are indexed upwards to reflect societal wage growth between such year and the age-60 year. The formula that then applies is meant to be modestly progressive, in that, as one’s thus-computed “average indexed monthly earnings” (AIME) increase, one’s monthly benefits rise in absolute terms, but fall as a percentage of the AIME. However, the degree to which the system is progressive as a whole for a given age
cohort is also affected by relative life expectancies for high-earners versus low-earners, since individuals who live longer get the monthly benefits for a longer period.

The end result of all this is that Social Security consists of “two imperfectly integrated Rube Goldberg systems, one on the tax side and one on the benefit side. Neither the two sides in isolation nor their relationship is well-understood by workers or voters” (Shaviro 2000, 19). Accordingly, tinkering with any one metric within the system has ripple effects, not just on the system’s overall fiscal balance, but also on how the members of particular age cohorts and wage levels end up doing under Social Security as a whole.

Under present law, Social Security has two types of automatic indexing. The first is inflation indexing, not just for retirees’ monthly benefits but also for the annual ceiling on wages that are subject to the Social Security payroll tax. The second is the above-noted indexing for real (as well as inflationary) wage growth during one’s working career up to age 60, for purposes of computing the AIME on which monthly benefits depend.

Other possible types of Social Security indexing have also been occasionally discussed, although not adopted. Perhaps the most prominent such proposal is to index the normal Social Security retirement age, at which point eligibility for benefits typically begins, to adjust automatically for societal life expectancy increases. At present, while there is no such indexing, the normal retirement age is slowly increasing from age 65, its level as recently as 2002, to age 67, which it will reach in 2025.

B. Inflation Indexing

---

13 On its face, Social Security’s tax side is considerably more straightforward than its benefit side. In the above quotation, I deployed the “Rube Goldberg” characterization for both, rather than just for the benefit side and the tax-benefit relationship, because the fact that the Social Security payroll tax is nominally split 50-50 between employers and workers may tend to obscure people’s understanding of how it operates.

14 Social Security participants can elect early retirement, causing monthly benefits to be lower, or late retirement, in which case they are higher, but the dates for these elections are set relative to the normal retirement age.
Inflation indexing for Social Security benefits, like that for income tax rate brackets, might be viewed as politically surprising, given that it deprives Congress of the credit for enacting the resulting nominal benefit increases, if not for the credit that initial enactors may reap\textsuperscript{15} and the subsequent convenience to incumbents of avoiding the risk of voter anger from any lag in responding legislatively to inflation. From a normative standpoint, however, the case for inflation indexing of Social Security benefits is, if anything, even stronger than that in the context of income tax rate brackets. Low-income seniors who depend on Social Security benefits for retirement support may otherwise be ill-positioned to cushion themselves against inflation risk.

Suppose all consumers purchased available goods and services in exactly the same relative proportions, which always remained fixed; or alternatively, that the rate of price level change for all items was uniform. Either way, computing the consumer price index (CPI), the federal government’s official measure of the inflation rate, would be uncontroversial, and the only reasonable ground for questioning straightforward CPI indexing of Social Security benefits would be as a mechanism for changing real benefit levels.

In actual practice, however, the inflation rate is not quite so tidy a concept. Some consumer items’ prices change differently than others, consumers may respond to these relative changes by altering the proportions of different items in their market baskets, and consumers differ systematically in the market baskets that they favor. This has led to a technical debate about how best to compute the CPI for Social Security (and other fiscal) purposes, which in turn

\textsuperscript{15} The 1972 decision to adopt inflation indexing for Social Security was spearheaded by powerful Ways and Means Chair Wilbur Mills, who at the time was planning for the Democratic presidential nomination. Conservatives, however, apparently supported on the ground that Congress would otherwise be likely to increase benefits in each election year by more than the inflation rate (Scheiber 2012, 74).
has served as grist for an indexing debate between people who favor higher versus lower real benefit levels for Social Security.

Two important alternatives to the standard CPI that the federal government’s Bureau of Labor Statistics (BLS) has recently been computing are as follows. First, under what is called Chained CPI, the BLS takes into account the fact that, when goods’ relative prices change, consumers to some degree substitute newly lower-priced goods for higher-priced goods. This reduces the welfare loss that they would suffer if they did not adjust, and leads systematically to a lower CPI measure. The difference over a recent ten-year period was about 0.24 percent annually – which may sound small, but would have reduced estimated Social Security outlays by $127 billion between 2014 and 2023 (Congressional Budget Office 2013, 5-9).

Second, through an experimental measure called the CPI-E, the BLS attempts to measure inflation for seniors in particular, by focusing on the purchasing patterns of individuals who are age 62 or older. Here, while in theory the shift could go either way, the historical effect has been to raise measured inflation (under both the regular CPI and the CPI-U) by about 0.2 percent annually (Brauer and Meyerson 2013).

Which CPI measure should one use, if the sole goal is to keep Social Security beneficiaries’ real benefit levels constant? The purely technical argument for the CPI-U is strong, given that substitution permits people to mitigate the adverse effects of uneven price increases, but that for the CPI-E is also strong if the question is how inflation affects seniors in particular. Unsurprisingly, however – and understandably, since there is no reason to assume that benefits are currently set just right, rather than being either too high or too low, all things considered – political debate seems to have been driven by the unambiguous real effects that changing the official inflation measures would have. Thus, shifting to the CPI-U has become a
favorite cause of those who favor reducing Social Security benefits relative to their path under current law, while shifting to the CPI-E is gaining prominence on the other side of the debate (Matthews 2013).

C. Wage Level Indexing

Wage-level indexing of average monthly earnings, to reflect real wage growth during the portion of one’s working career through age 60, is surely among the prime causes of the Social Security benefit computation’s mind-numbing non-intuitiveness. Yet, although such indexing was not adopted until 1977, before which time Congress had relied upon periodic ad hoc benefit increases, it has a logic that is rooted in the system’s structure and history (see Committee on the Social Security Notch Issue 1994).

One key reason for Social Security’s not directly relating benefits paid to taxes received was that this permitted retirees, for several decades after its adoption, to receive far greater value in benefits than they had contributed in taxes. Obviously, one could not realistically have enacted Social Security in 1935 – or, even if it was enacted, have used it to help seniors who had lost all their savings in the Great Depression – if no one could benefit until current workers had spent decades contributing to it (Shaviro 2000, 20). It thus is frequently called a Ponzi scheme – a term used even by one of its great defenders, the economist Paul Samuelson, who, in a Newsweek article published in 1967, called it “the greatest Ponzi scheme ever contrived” (Scheiber 2012, 74). But Samuelson’s work showed how, unlike the typical Ponzi scheme with an exploding growth rate, Social Security might actually be indefinitely sustainable under this model (see Samuelson 1958). All that this required was ongoing real wage growth, plus favorable demographics, in the form of a rising worker-to-retiree ratio by reason of population growth.
Under these assumptions, suppose that, via the payroll tax, a fixed percentage of current workers’ wages is used to fund current seniors’ benefits. With sufficiently favorable real wage growth plus demographics, the tax base will grow faster than a market interest rate (see Shaviro 2013). Accordingly, with this financing method, not only can the first generation of Social Security retirees get their benefits for free, but subsequent generations can indefinitely keep on getting more value than they put in, without threatening the system’s long-term solvency. In effect, this is an indefinitely sustainable, non-exploding version of a Ponzi scheme – if one even wants to follow Samuelson’s lead in calling it that – so long as the preconditions remain in place. In recent decades, however, stagnant real wage growth (especially in the range up to the payroll tax limit), plus the baby bust in recent decades, plus seniors’ rising life expectancies, have led to a reversal of the conditions that Samuelson anticipated, and hence to Social Security’s projected long-term fiscal imbalance.

While Congress never formally adopted the Samuelson method of having current-year payroll tax revenues determine current-year benefits, its frequent pre-1970s enactment of benefit increases reflected an informal notion that current seniors should get more if the tax base was growing. This reflected, not just a pay-as-you-go financing norm during those years, but also something like Samuelson’s notion that Social Security was an inter-generational compact allowing older age cohorts to share in the benefits of real growth that otherwise would accrue just to younger age cohorts. Explicit wage indexing, along with that for brackets in the formula that is used to determine benefits as a function of one’s “average indexed monthly earnings,” could be viewed as merely formalizing and regularizing this practice.

---

16 Samuelson viewed younger age cohorts’ willingness to accept this as reflecting a pay-it-forward rationale, as each period’s current workers would subsequently benefit from the share-the-wealth norm as retirees.
The use of wage indexing and associated adjustments to share the upside of rising wage levels between age cohorts has some normative appeal, not shared by pensions with a classic defined contributions (DC) structure, under which retirement benefits depend upon the performance of particular financial positions. Without it, in an era of significantly rising real wage levels, seniors who don’t save enough outside Social Security may face significantly lower living standards at retirement than their younger peers. While a DC structure, unlike wage indexing, can permit retirees to benefit from stock market appreciation, diversification principles might suggest having some of each, and the effect of wage indexing may be hard to replicate through outside investment.

While in principle one might like to evaluate the desirability of wage indexing in a benefit-neutral framework – since its design merits as an automatic adjustment mechanism are distinct from the question of how high or low benefits should be – in practice any challenge to it would likely come in the context of proposed benefit cuts. Thus, despite the technical nature of the pure design merits issue that wage indexing presents, in practice one would expect the right to be more hostile to it, and the left more supportive. Even with the question remaining open of how the unspecified component of current Social Security policy (from the system’s self-financing norm) should be addressed, each side may hope to gain in the long run if the specified component is closer to its preferences.

D. Life Expectancy Indexing

Rising life expectancies have a negative fiscal effect on Social Security, since it requires the system’s fixed real life annuity to be paid out for longer periods. If the system were akin to a private insurer that is trying to make money, one would think of it as having lost mortality bets, to its detriment, when people live longer. But from a social insurance standpoint, giving people
more money when they live longer is a feature, not a bug. Living longer increases one’s overall lifetime material needs, and thus the marginal utility of a dollar. Accordingly, all else equal, one should want to give more money to longer-lived than shorter-lived individuals.

Still, the greater payouts have to be financed. And if all age cohorts’ life expectancies should be increasing, then there is no implication that currently older participants should be getting greater transfers from younger ones. In general, if one anticipates living longer, this should motivate wanting to earn more income on a lifetime basis. One way to do this would be by retiring later.

There is also a second reason why rising life expectancies may imply retiring later. If a key reason for wanting to retire is physical decline, and if living longer means that one is generally declining more slowly, then one may be able to keep working for longer without the same disutility that this might previously have had. This argument does not apply, however, insofar as rising life expectancies merely reflect better medical responses to leading causes of post-retirement mortality (such as cancer and heart attacks), rather than generally slowed aging.

Congress’s decision gradually to raise the normal retirement age from 65 to 67 reflects the standard view that, when life expectancies increase, people should retire later. Under that view, however, it may also make sense to enact automatic indexing, so that the normal retirement age will recede further if, and insofar as, life expectancies keep growing. The rationale might be either or both of (a) believing the two factors should be related, whether this affects overall benefits or not, and (b) making it easier to cut lifetime benefits, via an automatic process that would become part of current law. However, the second of these rationales may not appeal to those who favor smaller or no benefit cuts. Likewise, the first rationale can be challenged
insofar as people’s ability to work comfortably in their mid-60s and beyond is not increasing, even if they live longer.

The merits of adopting automatic life expectancy indexing are further complicated by Social Security’s lack of a clear relationship between the tax and benefit sides. Suppose that Social Security had been converted into a system using DC private accounts, as the George W. Bush Administration proposed in 2005. Under such a system, postponing the normal retirement age might simply mean that people worked longer, paid more money into the accounts, and then got it all back through higher benefits post-retirement. But under the existing system design, if later retirement is a standalone change (or part of a broader package) that is used to reduce the current fiscal imbalance in Social Security, it will have distributional effects, both within and between age cohorts, that do not necessarily follow from accepting the link between life expectancy and the normal retirement age. Thus, it has been argued (Krugman 2012), although also contested (Biggs 2012) that, in part because high-earners live longer, raising the retirement age will tend to be regressive.

V. CONCLUSION

Heraclitus was right – one can’t step into the same river twice, in the sense that policy almost has to change, or at least it must be more fully specified in order to be called the same, as surrounding circumstances change. His disciple was also right – we can’t ever quite fully know where we are, because how current policy would apply under various contingencies is likely always to be unclear. Observed current policies are typically consistent with multiple underlying meta-policies, and a fiscal imbalance means that the true long-term policy being followed remains unspecified.
Automatic indexing rules that reflect one’s own preferred meta-policy are easy to endorse. It is hard to see grounds for objection that are based, say, on preserving future policymakers’ discretion. Whether there is indexing of any kind or not, they can change the laws on the books if they so choose. Moreover, there will be some default outcome, favored by legislative inertia, whether there is indexing or not, and it is hard to generalize about indexing’s effects on agenda control. Thus, debate about particular proposed indexing rules should focus on whether or not one favors the meta-policies that they express.

Under the U.S. federal income tax, there are good arguments for expanding indexing to address real bracket creep, and for Rising Tide and tax smoothing-based automatic adjustment mechanisms, if one favors the underlying meta-policies. For Social Security, the evaluation of automatic indexing mechanisms (or their revision) is complicated by the fact that, given the murky relationship between individuals’ taxes and benefits, technical arguments for and against a particular type of adjustment may get subsumed into underlying political battles regarding both its distributional effects and how its benefit levels, as opposed to its tax levels, should change.

BIBLIOGRAPHY


http://eml.berkeley.edu/~auerbach/AG%202014-09-04.pdf.


