

ELECTION 2008:
A GUIDE TO ANALYZING THE ISSUES



**The Questions
Candidates Should Answer
About Social Security Reform**



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PREFACE

This guide has been written by the American Academy of Actuaries' Social Insurance Committee for the general public, including journalists, policymakers, and citizens to use as they evaluate candidates' proposals during the 2008 election cycle. The Academy is a nonpartisan, non-profit organization of actuarial professionals. While the Social Insurance Committee does not specifically endorse or oppose any of the reforms discussed in this guide, the committee strongly believes that Congress and the administration must take action to reform Social Security, and that action is needed sooner rather than later.

INTRODUCTION

Each year the board of trustees of the Social Security program* issues a report about the program's financial condition. In great detail, the trustees' report presents their assessment of the financial condition of Social Security for the next 75 years. The 2007 trustees' report shows that, based on the trustees' intermediate or "best estimate" assumptions, benefits and administrative expenses are projected to begin exceeding payroll tax income in 2017; and the Social Security trust funds are projected to run out of money in 2041, after which benefit payments must be limited to what can be funded by the payroll tax.

The Academy previously published a monograph, *Social Security Reform Options*, as well as a series of issue briefs analyzing proposals for reforming Social Security including their impact on benefits and solvency. This guide summarizes some of the main points from these publications and suggests questions that should be considered when analyzing any proposed changes to the Social Security system. We encourage you to access these documents at www.actuary.org for a more in-depth analysis.

While reading this guide, it is important to keep in mind the effect any proposed changes to the Social Security program would have on different demographic groups (i.e., women compared with men, low income compared with high income, or young compared with elderly).

*Officially the Old-Age, Survivors and Disability Insurance (OASDI) Trust Funds.

FINANCING

Social Security is financed primarily by a dedicated payroll tax shared equally, in most circumstances, by covered workers and their employers. The tax is a flat percentage of earnings up to a maximum amount, called the Social Security wage base, which is indexed each year to increases in the national average wage. Social Security also receives interest income from the investment of trust fund assets in government bonds and small amounts from other sources.

According to the intermediate estimates in the 2007 trustees' report, the current tax rate of 12.40 percent would have to be increased by 1.92 percent, to a rate of 14.32 percent, to support the estimated benefit payments and administrative expenses for the 75-year projection period in the report.

Questions to consider when analyzing a candidate's proposal to change the financing of Social Security:

- Should the Social Security tax rate be raised to strengthen system finances?
- Should the Social Security tax rate be indexed in some way so that taxes increase automatically when projections show the system is inadequately financed?
- Should the Social Security tax be graduated (according to income brackets) like income tax?
- Should general revenue, or revenue from another source such as a value-added tax, be used to supplement the Social Security payroll tax?
- Should the wage base be increased beyond the level specified by the current indexing formula, or even eliminated altogether as in Medicare, so that all earnings are subject to the payroll tax? If so, would the newly taxed earnings be included in earnings for calculating Social Security benefits?
- Should a portion of trust fund assets be invested in securities other than government bonds with possible greater risks and potentially higher investment returns?

CHANGES TO THE BENEFIT FORMULA

Historically, Social Security has provided benefits related to workers' earnings during their careers. The benefit formula is indexed to wage inflation before retirement and to the cost of living after retirement. Ben-

efits calculated in the current Social Security formula replace a much higher portion of lifetime average earnings for lower-paid than for higher-paid workers. For example, the replacement rate (i.e., the percentage of a worker's pre-retirement earnings that is replaced by Social Security) at normal retirement age is about twice as high for a worker whose career earnings average 45 percent of the national average wage than for a worker whose earnings always have equaled the Social Security wage base. This progressive benefit formula is the primary method through which the program addresses adequacy of benefits for workers with low earnings.

Questions to consider when analyzing a candidate's proposal for changes to Social Security's benefit formula:

- If savings come primarily from reducing benefits for high-income workers, would the program retain support among those workers?
- How would a proposed change affect the standard of living during retirement for workers and their family members at different income levels?
- How would a proposed change affect the standard of living for disabled workers and beneficiaries of deceased workers at different income levels?
- How would a proposed change affect the benefits of divorced spouses?
- Would it be acceptable to make benefit changes contingent on system finances so benefits decrease, or do not increase as rapidly, when projections show the system is inadequately financed?

CHANGES TO THE TAXATION OF BENEFITS

In general, annuities are included in income for tax purposes except for any portions that already have been taxed. Before 1983, no portion of a recipient's Social Security benefits was included in income for tax purposes. Today, if a recipient's adjusted gross income, plus non-taxable interest income, plus one-half of the Social Security benefit, exceeds a specified threshold, then a portion (which could be up to 85 percent) of the Social Security benefit is included in taxable income. This threshold is \$25,000 for a single person and \$32,000 for a married couple filing jointly. Unlike most dollar thresholds in Social Security and income tax formulas, these are not indexed for inflation in prices or wages. Revenue from taxation of Social Security benefits does not go into the federal government's general fund like other income tax receipts. It is used to help finance Social Security and Medicare.

Questions to consider when analyzing a candidate's proposal for changes to the taxation of Social Security benefits:

- Should Social Security benefits be taxed like other forms of annuity income? How would such a change affect lower-paid versus higher-paid workers?
- Should the current income thresholds for determining what portion of a recipient's benefit is subject to taxation be updated and/or indexed for inflation?
- Would changes to benefit taxation influence when workers decide to retire?
- Would changes in the taxation of Social Security benefits affect how retired workers time their receipt of other retirement benefits? For example, might such changes discourage annuitization of personal savings?
- Should revenue from the taxation of Social Security benefits continue to be split between Social Security and Medicare, go entirely to Social Security, or go to the federal government's general fund like other income tax receipts?

MEANS TESTING

Among proposed Social Security reforms is the reduction or elimination of benefits for wealthy and/or high-income participants and beneficiaries, generally characterized as “means testing.” Advocates of means testing note that reducing or eliminating benefits for those whose income or assets exceed certain thresholds would reduce Social Security's financial deficit while helping to preserve Social Security as a safety net for those who truly need it. Underlying means testing is the belief that government-sponsored programs should be targeted at lower-income segments of the population and that government funds should not be used to aid those who are not in financial need.

On the other hand, Social Security benefits are currently based on a worker's covered wages. This link between the wages that have been taxed during a worker's career and the benefits the worker receives after retirement establishes an “earned right” in the minds of program participants, which is part of the basis for the program's popular support. Since Social Security's inception, the program has paid benefits to all workers who have worked in covered employment for a sufficient period, and to their family members and beneficiaries, without regard to wealth. This universality reinforces the idea of Social Security as an earned right.

There are a number of concerns associated with means testing. Of primary concern is the potential erosion of popular support for the system if the earned-right principle is modified or abandoned. Further, if saving for retirement reduces workers' Social Security benefits, they may not save as much outside Social Security. Additionally, because means testing could encourage people to divert their assets and income in order to reduce their taxable income due to the means test, additional and potentially elaborate rules would be needed to discourage these actions.

Questions to consider when analyzing a candidate's proposal for means testing:

- Should means testing be based on income or assets, or both?
- How would the proposal measure income and/or assets?
- How does the proposal determine the appropriate income and/or asset threshold for benefit reductions?
- How would means testing be administered?
- Should Social Security be modified to resemble a government welfare program?
- Would such a change in philosophy weaken public support for the program?
- Would direct savings from means testing be largely offset by indirect costs, such as reduced incentives to work or save for retirement, legal or illegal avoidance of benefit reductions, and increased administrative or oversight costs?
- Could alternatives, such as changing the benefit formula or taxation of benefits, achieve similar results within the current program structure?

RAISING THE NORMAL RETIREMENT AGE

When the Social Security program began paying monthly benefits in 1940, workers could receive unreduced benefits beginning at age 65—the normal retirement age (NRA). The law was changed in 1983 to increase the NRA gradually, beginning in 2000, from age 65 to age 67, recognizing at least in part that longevity had increased greatly. Raising the retirement age further could significantly improve Social Security's financial status.

The financial problems of Social Security are partly due to workers living longer now than in the past and receiving benefits for a longer period of time. Since Social Security began paying monthly benefits, life expect-

tancy for both men and women has increased several years. Moreover, the trustees anticipate further significant increases in life expectancy during the 75-year projection period.

To further complicate this situation, studies have shown that the average age of retirement in the United States decreased through the mid-1980s. The combination of living longer and retiring earlier means that Social Security must pay benefits for a longer period of time, while payroll taxes are collected for a shorter period.

Proposals calling for an increased normal retirement age include: ad hoc increases to the NRA; indexing the NRA to keep the average benefit payment period the same; indexing the NRA to keep the ratio of retirement years to working years the same; and adjusting the NRA as necessary to maintain actuarial balance.

Present law requires workers to wait until the early eligibility age, currently 62, to receive benefits, which are reduced for retirement before the NRA. Some proposals would raise the early eligibility age in addition to the NRA.

Questions to consider when analyzing a candidate's proposal for raising the retirement age:

- Do improvements in older workers' health and longevity justify delaying the age requirement for full benefits?
- If workers must work longer to receive full Social Security benefits, would jobs be available for them? Is the answer the same for men and women?
- How would raising the normal retirement age for workers affect the benefits of family members?
- If the age requirement for full benefits is increased, should the early eligibility age be increased as well?
- To what extent would cost savings be offset by additional disability benefits?
- Would raising the retirement age place a particular burden on certain occupational groups?
- How would raising the retirement age affect Medicare and employer-sponsored health and retirement plans?

INDIVIDUAL ACCOUNT PROPOSALS

Many Social Security proposals call for workers to accumulate a portion of their payroll taxes in individual accounts to fund retirement income. These can be either additional taxes on top of the current schedule (add-on accounts) or a portion of the current scheduled taxes (carve-out accounts). Add-on accounts would leave the current Social Security system intact. Carve-out accounts would redirect a portion of the payroll taxes previously used to support benefits provided under the current formula, so that the formula would have to be reduced (in addition to any reductions otherwise required to achieve long-term solvency). Proponents of carve-out accounts believe such benefit reductions would be more than offset by the greater returns that can be achieved by individual accounts invested in the securities markets.

The current system is a defined benefit program, in which the contributions of all workers are pooled and available to pay benefits to any worker or any worker's family members. In contrast, individual accounts would be based directly on a worker's contributions, plus investment earnings, and would be available only to pay benefits to that particular worker and his or her family members.

Opponents of carve-out accounts are concerned about reducing Social Security's guaranteed benefits and diverting payroll taxes that would otherwise be used for paying current benefits.

Questions to consider when analyzing a candidate's proposal for individual accounts:

- Would workers' individual accounts be mandatory or voluntary?
- Would individual accounts be added to the current program or would they replace a portion of the current program?
- How would the program protect benefits for older workers and retirees?
- Would the program continue to provide a basic level of support for older workers and retirees?
- In a carve-out approach, how high an investment return would a worker need to receive the same benefits as under the current formula?
- Would higher-income workers subsidize the accounts of lower-income workers? If not, how will the program address the possibility that benefits would be inadequate for lower-income workers?
- How would the program provide adequate benefits to workers who become disabled early in their careers, or to the survivors of workers who die early in their careers?

- Would individual account funds be shared upon divorce?
- Would the transition to individual accounts require financing from general revenue? If so, how much?
- Would individual accounts be managed and invested centrally, or would workers be allowed to choose their own investment managers?
- How many investment alternatives would workers be offered, and what would they be?
- How would workers be educated to make informed investment decisions?
- Under what circumstances, if any, would workers be allowed access to their accounts before retirement?
- How would record keeping, investment management, worker education, and other services associated with individual accounts be handled? How much would these cost, and how would they be financed?
- Would small accounts have proportionately larger expenses, or would they be subsidized?
- Would payout of benefits by lifetime annuities be mandatory or voluntary? If annuities are voluntary, how will the program address the risk that employees who do not elect annuities will outlive (or outspend) their retirement accounts? How would payout annuities be designed, priced, and administered?

PUBLIC STATEMENTS ON SOCIAL SECURITY BY THE AMERICAN ACADEMY OF ACTUARIES

The following publications and other relevant documents are available on the Academy website at www.actuary.org/socsec/index.htm, or can be ordered by contacting the Academy directly (see Page ii).

2007

Social Security: Evaluating the Structure for Basic Benefits (September 2007 issue brief)

Women and Social Security (July 2007 issue brief)

An Actuarial Perspective on the 2007 Social Security Trustees' Report (May 2007; issue brief updated annually)

Investing Social Security Assets in the Securities Markets (March 2007 issue brief)

Social Security Reform Options (January 2007 monograph, accompanied by a news release)

News media briefing on Social Security reform options (Jan. 18, 2007)

2006

Social Security Reform: Changes to the Benefit Formula and Taxation of Benefits (October 2006 update of issue brief)

An Actuarial Perspective on the Social Security Trustees' Report (May 2006; issue brief updated annually)

2005

A Guide to the Use of Stochastic Models in Analyzing Social Security (October 2005 issue brief)

Testimony for a House hearing on strengthening Social Security, plus background material cited in the testimony (June 14, 2005)

An Actuarial Perspective on the 2005 Social Security Trustees' Report (April 2005; issue brief updated annually)

Material from a Capitol Hill briefing on Social Security and Medicare solvency issues (April 2005)

Material from a news media briefing on options for Social Security reform (March 2005)

2004

"Social Security Reform: Solutions Outside the Box" (Capitol Hill briefing, May 3, 2004)

"Social Security Reform: Solutions Inside the Box" (Capitol Hill briefing, April 16, 2004)

Social Security Benefits: Changes to the Benefit Formula and Taxation of Benefits (April 2004, issue brief updated annually)