Social Security Reform:
Solutions Inside the Box
Proposals Not Including Individual Accounts

A Luncheon Briefing Sponsored By

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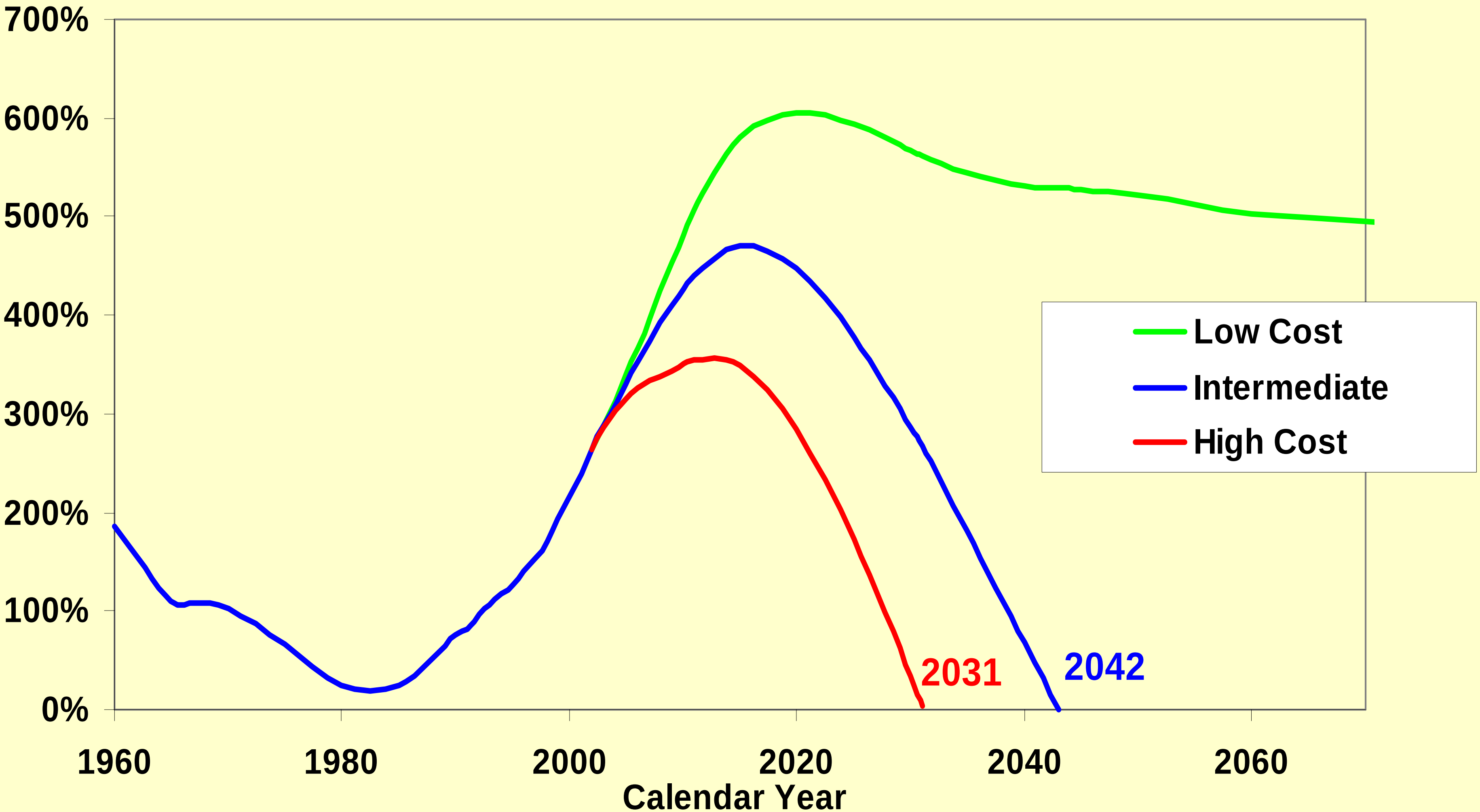
Social Security's Financing Problem

Social Security's Financing Problem

- **2004 Trustees Report shows**
  – Expenses will exceed payroll tax income by 2018
  – Trust funds will run out of money in 2042
- **75-year deficit equals 1.89% of taxable payroll**
  – Immediate payroll tax increase of 1.89% needed to restore actuarial balance
  – Alternatively, immediate13% across-the-board benefit cut
- **Based on intermediate ("best estimate") assumptions**

Social Security Trust Fund Ratios

(Beginning of Year Assets as a % of Expenditures)



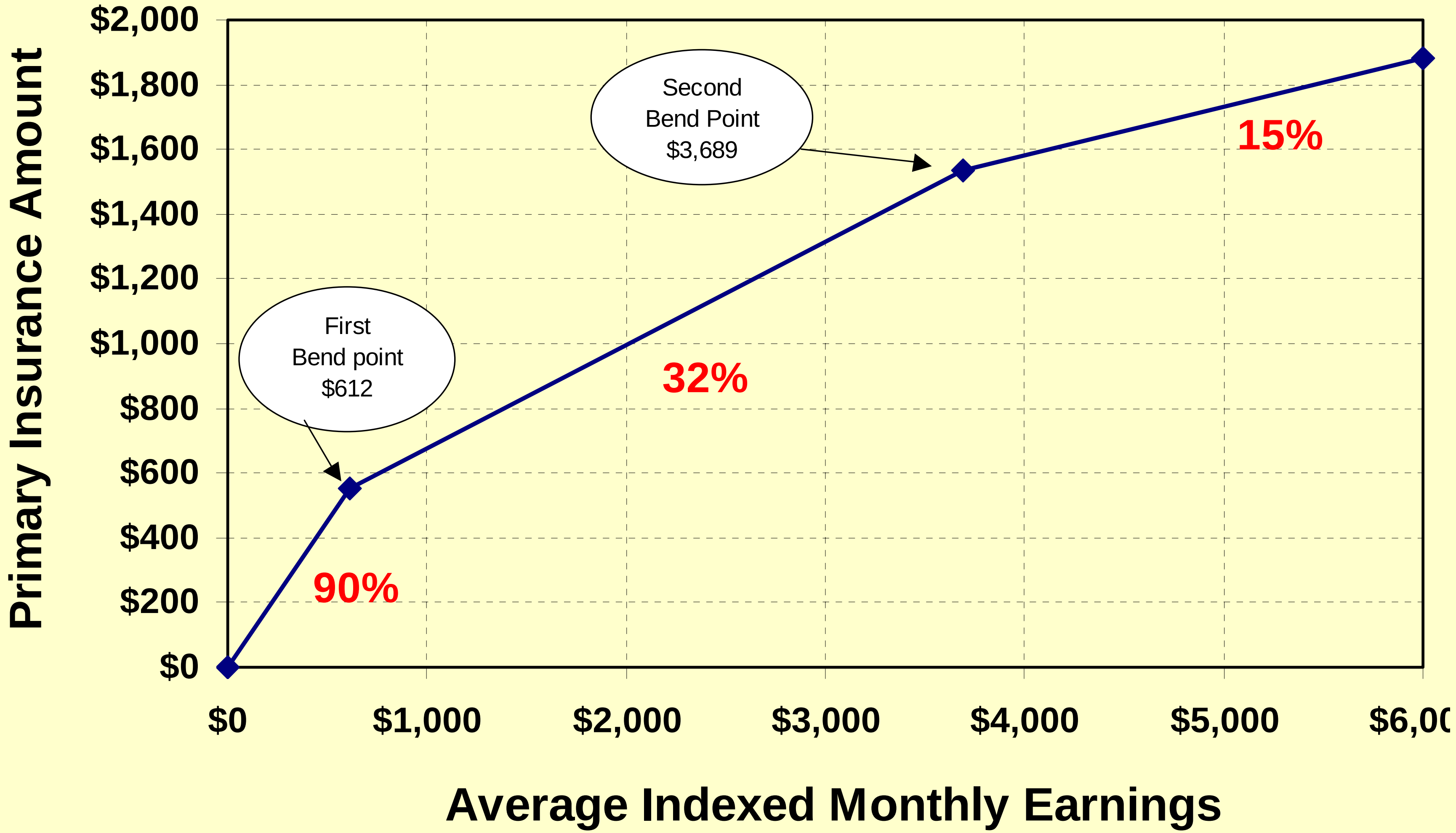
Changes to the Benefit Formula

Current Benefit Formula

- **Based on workers' average indexed monthly earnings (AIME) during their careers**
  - 90% of first $612 of AIME
  - 32% of AIME from $612 to $3,689
  - 15% of AIME over $3,689
- **Result is called Primary Insurance Amount (PIA)**
- **Wages indexed by wage inflation up to age 60**
- **PIA indexed by the cost of living after age 62**
- **Provides higher benefits relative to earnings for the lower paid**

Primary Insurance Amount (PIA) formula

for persons turning age 62 in 2004



Changes to PIA Factors

- **Reduce 90%, 32%, and/or 15% factors**
- **Across the board reduction**
  - For example, reducing factors by 1% each year until desired reduction attained
  - Would maintain current progressivity while reducing adequacy
  - Indefinite 1% annual reduction would cut replacement ratios in half about every 70 years and approximately eliminate deficit
- **Alternatively, reduce only 32% and 15% factors**
  - Would increase progressivity and maintain adequacy for very low earners
- **Another alternative: a minimum benefit**

Changes to PIA Bend Points

- **Reduce $612 and $3,689 relative to low wage levels**
  - Currently bend points indexed to wage inflation
  - One or both bend points could be indexed at a lower rate
  - For example, to price inflation, which is usually about 1% lower
- **Targeting both bend points would yield across-the-board benefit reductions**
- **Targeting only higher bend point would tilt reductions toward the higher paid**

Changes to the AIME

- **Currently based on high 35 years earnings**
  - Each year’s earnings indexed to age 60 by wage inflation before averaging (earnings at age 60 and older not indexed)
  - Benefits based on earnings relative to prevailing wage levels
- **Increase averaging period to 38 or 40 years**
  - Would lower benefits about 3% on average
  - Would particularly affect workers with shorter careers or less consistent earnings
  - Effect on stay-at-home parents could be mitigated by allowing additional dropout years for childcare
  - Increase to 40 years would reduce deficit by about 21%

Cost-of-Living Adjustments

- **Some economists say CPI overstates inflation**
  - Does not fully reflect substitution of products whose prices increase more slowly for those whose price increase more rapidly
  - Estimated overstatement - about 0.22% per year
- **Reducing COLA would reduce benefits and help restore actuarial balance**
  - Could be instituted quickly, would apply to retirees and workers
  - Reducing COLA by 0.5% would reduce deficit by about 40%
  - And reduce benefits by 5% after 10 years and 9% after 20 years
- **Alternative: separate "retiree CPI"**
  - Would increase COLA by 0.3% per year according to BLS study

Double-Deck Benefit Formula

- **Double-Deck Benefit Formula**
  - First deck – flat dollar amount for all workers who meet service requirements
  - Second deck – flat percent of AIME
- **Proponents say separating adequacy and equity components would make system stronger**
- **Opponents disagree**
  - Could diminish support among highly paid
  - Could lead to general revenue financing of first deck, making it effectively a welfare benefit

Auxiliary Benefits

- **Reduce benefits for spouses and dependent children**
  - For example, reduce non-working spouse's benefit from 50% to 33% of worker's benefit
  - Or reduce factors and/or bend points in formula for maximum family benefits
- **May include features to increase equity between one-earner and two-earner couples**
  - However, such features usually result in cost increases rather than decreases

Changes to the Taxation of Benefits

Current Taxation of Benefits

- No tax unless AGI plus non-taxed interest plus 50% of Social Security exceeds $25,000 if single, $32,000 if married filing jointly
- Up to 50% of benefits taxable if applicable income $25,000 - $34,000 (S) or $32,000 - $44,000 (M)
- Up to 85% of benefits taxable above those ranges
- Threshold amounts not indexed
- Revenue from taxation of first 50% of benefits goes to OASDI, additional revenue goes to Medicare (HI)
- No indexing of thresholds means number of recipients taxed and portion of benefits taxed increases each year

Changes to Taxation of Benefits

- **Introduce indexing of thresholds**
  - Would decrease number of recipients taxed and proportion of benefits taxed
  - Would decrease income to OASDI and Medicare trust funds
- **Tax Social Security like other annuities**
  - All benefits in excess of non-tax-favored contributions taxed
  - Would increase taxable benefits for most recipients
  - But taxes would increase little if any for the low paid due to progressive tax formula
- **Leave tax receipts from Social Security benefits in general revenue**
  - Would worsen financial health of Social Security

Changes to Normal Retirement Age

Current Normal Retirement Age

- **Before 1983 law, age 65 for everyone**
- **1983 amendments gradually increase NRA beginning in 2000 to age 67**
  - No change for workers born before 1938
  - Age 67 effective for workers born after 1959
- **Early retirement at age 62 still available, but with larger actuarial reduction**
- **This was the principal means for reducing long-range costs in the 1983 amendments**

Rationale for Raising the NRA

- **Workers are living longer, healthier lives**
  - Workers are able to remain longer in the workforce
  - Workers will need more time to save for a longer retirement
- **Possible difficulties**
  - Will workers want to remain longer in the labor force?
  - Will more jobs be available for older workers?
  - Will workers in strenuous jobs be adversely affected?

Alternative Methods for Setting the NRA

- Ad hoc changes, as in the 1983 amendments
- Indexing the NRA to keep the average payout period the same
- Indexing NRA to keep the ratio of working to retirement years the same
- Indexing NRA to maintain actuarial balance (assuming the system has been put in actuarial balance)

Financing Social Security

Current Financing

- **Dedicated payroll tax shared equally by employer and employee**
- **Flat percentage, 12.40%, of wages up to a maximum level, the wage base**
- **Wage base indexed to wage inflation**
- **Payroll tax receipts in excess of expenses go to a trust fund invested in government bonds**
  - Treasury issues special non-marketable bonds specifically for this purpose
  - Interest rate set at average of outstanding publicly held bonds

Changes to Payroll Tax

- **Increase payroll tax rate**
  - According to 2004 Trustees' report, 14.29% required to support system
  - Can expected productivity gains support a higher payroll tax rate?
- **Increase the wage base**
  - Would increase payroll tax receipts immediately
  - If newly taxed earnings included in benefit formula, would increase benefits later
  - The system would still come out ahead financially
  - The maximum taxable wage has been eliminated entirely for Medicare
- **Make the payroll tax progressive, like the income tax**
  - Could reduce support for Social Security among the highly paid
- **Supplement the payroll tax with general revenues**

Changes to Trust Fund Investments

- **Invest some or all trust fund assets in equities**
- **Advantages**
  - Could achieve higher long-term investment returns
  - Could increase total investment in economy, spur productivity gains; but may only shift sources of investment
- **Disadvantages**
  - Greater volatility in investment returns
  - Artificial inflation of market values when trust fund expands, deflation when trust fund contracts
  - Possibility of direct government interference in capital markets and corporate governance

Means Testing

Means Testing Concepts

- **Reduce or eliminate benefits for wealthy and/or high income recipients**
  - Would reduce Social Security's financial deficit
  - Would preserve a safety net for the less wealthy and/or lower paid
- **Underlying principle: government financed programs should be targeted at the truly needy**
  - Would weaken current "earned right" and "universality" principles

Advantages and Disadvantages of Means Testing

- **Advantages**
  - Reduce Social Security's financial deficit
  - Use scarce government resources more efficiently
- **Disadvantages**
  - Risk of eroding public support for Social Security, particularly among the well-off
  - Possible disincentive to save for retirement
  - Introduces administrative complexity
  - Potential for fraud and abuse

Alternatives to Means Testing

- Adjust benefit formula to reduce benefits for highly paid
- Increase taxation of Social Security benefits for the highly paid
- Both achieve similar results within current structure
- Some of the same disadvantages apply

Options

	% of Deficit Eliminated
• Decrease Benefits	
– Raise retirement age (to 67 faster & index)	33%
– Reduce COLA by ½%	41%
– Cut initial benefits by 1% each year	100%
– Affluence Test (Concord)	75%
– Increase # of yrs in wage avg. to 40	21%
• Increase Taxes	
– Increase tax rate by 1% in total	51%
– Increase wages subject to tax by 1/4	26%
– Tax SS benefits like pensions	20%
– Include rest of state & local govt.	10%
• Increase Investment Returns	
– Investment in equities	36%- 50%

Social Security Reform:
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