Social Security: Reform Proposals and Trust Funds

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Summary of the Financial Status of Social Security

- Based on 2011 Trustees Report, 75-year valuation period, intermediate assumption set
- Actuarial balance: -2.22% of taxable income
- 2.15% increase in payroll tax (12.40% to 14.55%) required to eliminate deficit
- Or, alternatively, 14% immediate cut to all current and future benefits
- Or some equivalent combination of tax increases and benefit cuts

Key Dates

- 2011: tax income is expected to be less than benefits and administrative expenses
- 2022: total program income (including investment income) is expected to be less than total program outgo
- 2036: the Social Security trust fund is expected to become exhausted

Social Security Basics

- Earned Right and Universality: the twin pillars of social insurance
- Earned Right: Social Security’s benefit formula starts with the earnings on which the worker and employer have made contributions
- Universality: Social Security pays benefits to all who have worked in covered employment for a sufficient period, and to their family members and beneficiaries, without regard to wealth or other income
- Together, they distinguish Social Security both from broadly available subsidies, such as the mortgage interest deduction, and narrowly defined income maintenance programs, such as food stamps (SNAP)

Social Security Basics

- Individual Equity *vs.* Social Adequacy: the social insurance balance
- Individual Equity: benefits represent the true actuarial value of contributions, like a commercial insurance policy
- Social Adequacy: benefits fill the specific needs of recipients, like a welfare program
- Social Security contains elements of both: benefits are higher for workers with a history of higher earnings, but provide a proportionately greater benefit for lower-income workers

Social Security Basics

- Social Security is financed primarily by a payroll tax of 6.2% each on workers and their employers on income up to the taxable earnings base ($106,800 in 2011, $110,100 in 2012)
- Other sources of income: investment earnings and income tax on 50% of benefits for recipients with taxable incomes over $25,000 ($32,000 for couples)
- All income is held in the Social Security Trust Funds (Old Age and Survivors and Disability), which are invested in non-marketable special-issue U.S. government securities
- Social Security benefits are paid exclusively from Trust Fund assets
- Although Congress has stated its intent that Social Security be financed on a pay-as-you-go basis, since the 1983 amendments the system has built up a $2.6 trillion trust fund, expected to reach $3.7 trillion by 2022

Social Security Basics

- Average Indexed Monthly Earnings (AIME): average of high 35 years of annual earnings beginning at age 22 indexed by the National Average Wage, but not beyond age 60, divided by 12
- Primary Insurance Amount (PIA): 90% of AIME up to $767, plus 32% of AIME from $767 up to $4,624, plus 15% of AIME exceeding $4,517 (2012 formula)
- Bend points indexed by the National Average Wage
- Benefits indexed by Consumer Price Index (CPI) from earlier of the benefit start date or age 62

Social Security Basics

- Old age benefit: unreduced at age 66 (scheduled to increase to 67), reduced at age 62
- Disability benefit: unreduced regardless of age, must be unable to work in gainful employment
- Spouse benefit: 50% of worker's benefit offset by spouse's own benefit
- Survivor benefits: 100% of worker's benefit to surviving spouse offset by spouse's own benefit, plus additional benefits to surviving children up to age 19

Office of the Actuary Web Addresses

http://www.ssa.gov/OACT/solvency/index.html

http://www.ssa.gov/OACT/solvency/provisions/index.html

Reform Proposals: Tax Changes

- Increase the payroll tax rate: 2.15% increase (12.40% to 14.55%) required to eliminate deficit, more if increase phased in
- Increase taxable earnings base: currently includes about 83% of earnings in covered employment; raising gradually to 90% (about a 25% increase) would eliminate 35% of the deficit
- Increase taxation of benefits: taxing Social Security benefits like pension benefits would eliminate about 16% of the deficit
- Expand coverage: bringing in non-covered groups, primarily government employees in opt-out states, would eliminate about 10% of the deficit.

Reform Proposals: Benefit Formula Changes

- Reduce benefits across the board: 14% immediate cut to all current and future benefits required to eliminate deficit, more if some benefits excluded or reduction phased in
- Price indexing: 1.1% per year reduction in formula percentages, equivalent to historic average excess of wage increases over price increases, would eliminate the entire deficit if carried on long enough, but also drastically reduce benefits
- Progressive price indexing: formula percentages recalculated annually so that wage indexing applies to bottom 30% of workers, price indexing to maximum earners, with linear interpolation in between
- Longevity indexing: reduces the formula percentages proportionately to increases in longevity; used by some European countries

Reform Proposals: Benefit Formula Changes

- Lengthen AIME averaging period: increasing averaging period from 35 to 40 years would eliminate about a quarter of the deficit
- Reduce COLAs: adopting “chained” CPI would reduce annual increases by an estimated 0.3%, eliminating 26% of the deficit
- Double-Deck Formula: flat dollar amount (first deck) plus flat percentage of AIME (second deck)
- Change ancillary benefits: reducing spouse percentage to 33% eliminates 6% of the deficit; providing a minimum surviving spouse benefit of 75% of couple’s combined benefit improves equity between one-earner and two-earner couples but increases deficit

Reform Proposals: Raising the Normal Retirement Age

- Only potential change that responds directly to one of the causes of Social Security's actuarial deficit, *i.e.*, increasing longevity among workers
- Since 1940, life expectancy at age 65 has increased about 5 years for both men and women, and is projected to increase another 5 years by 2085
- Since 1940, the NRA has increased by 1 year, with an additional 1 year increase scheduled by 2027
- Increasing the NRA one month every two years approximates the projected rate of increase in life expectancy at age 65 and reduces the deficit by 18%
- *Ad hoc* increases to offset partially or fully past increases in life expectancy would reduce the deficit further

Reform Proposals: Individual Accounts

- Typical proposal: 4% of covered earnings (2% each for employee and employer) diverted from trust funds to individual accounts, *i.e.*, an individual account carve-out
- Worker can choose among a limited number of options for investing his/her account
- Current formula benefit offset by annuity purchased by account balance using a target investment return assumption
- Worker receives higher benefit if actual account earnings exceed the target assumption, lower benefit if actual earnings less than target assumption

Reform Proposals: Individual Accounts

- This approach does nothing by itself to ameliorate Social Security’s financial problems
- Individual account carve-out usually coupled with a decrease in the current benefit using one of the mechanisms described earlier
- The goal is that benefits lost through decreases in the current benefit will be made up by investment earnings in excess of the target rate

Reform Proposals: Individual Account Issues

- Should the accounts be mandatory or voluntary? If voluntary, can workers change their elections?
- How many investment options should there be and who should manage the investments?
- Should workers be required to annuitize all or a portion of their accounts at retirement?
- What forms of annuity should be offered?
- This approach was pronounced dead after failure of Bush initiative, but has been resurrected by Rep. Paul Ryan among others

Reform Proposals: Other Possible Changes

- Invest trust fund assets in publicly traded securities, particularly equity securities
- Add an income and/or wealth test to the benefit formula
- Create a new source of dedicated funding, such as a value added tax (VAT)
- Use general revenues to make up any funding shortfall

National Commission on Fiscal Responsibility and Reform

- Add a new bend point at the median income level, about $3,167 currently (between the existing bend points), and change the formula percentages to 90%, 30%, 10% and 5%, phased in by 2050
- Provide a minimum benefit of 125% of the poverty level for a worker with 25 years of covered employment
- Index the NRA to longevity and increase earliest eligibility age in tandem after 2027
- Direct SSA to create a “hardship exemption” from future increases in the NRA and ERA for workers in physically demanding occupations
- Increase benefits 5% 20 years after earliest eligibility age for old age benefits

National Commission on Fiscal Responsibility and Reform

- Increase taxable earnings base to cover 90% of earnings, phased in by 2050
- Adopt the chained CPI
- Cover newly hired state and local government workers beginning in 2020
- Allow workers to initially receive only half their benefits
- Adoption of total package would eliminate 112% of actuarial deficit (based on 2010 Trustees Report)

Are the Social Security Trust Funds "Real"?

- Social Security's assets are debts of the US Treasury
- Under Federal accounting rules, Social Security is "off-budget," *i.e.*, it is treated as an entity outside the government
- Thus, the debts the government owes to Social Security are part of the national debt
- If the trust fund assets are not real, then neither are the debts they represent, so the national debt would be about $2.6 trillion less than reported
- Whether the trust funds are real depends on your point of view

The Trust Funds From Social Security's Point of View

- Like all treasury debt, trust fund assets are backed by "the full faith and credit of the US Government;"
- The government has never defaulted on its debt, and the favorable interest rates the government pays reflects the consensus that default is extremely improbable
- The trust funds are the only source available to the Social Security Administration for benefit payments
- If the trust funds become exhausted, SSA can pay only those benefits that can be funded by current income
- In this sense, the trust funds are very real and tangible

The Trust Funds From the Whole Government Point of View

- Even though Social Security is off-budget, it is still a part of the government
- Social Security income not immediately needed to pay benefits is available for other government purposes
- Until the trust funds are exhausted, money needed to make up any income shortfall must be diverted from other government purposes
- Since Social Security tax is less progressive than income tax, overall taxation is less progressive during trust fund build-up and more progressive during draw-down; thus, to the individual tax-payer the trust funds can have a very real effect
- Does the availability of the trust fund assets lead to higher government spending? Theories abound.

The Trust Funds From the Whole Economy Point of View

- The key question: Do the trusts funds cause national savings to increase?
- Answer: Only if they cause a net decrease in spending.
- Since trust fund assets are spent immediately, they do not directly increase national savings, although they may indirectly affect national savings (either way) by changing workers' private spending and savings behavior
- In this sense, the trust funds are not real
- However, by this same standard, no fund of securities can be considered real, including insurance company general and separate accounts and pension funds

Where Does This Leave Us?

- No economic view of Social Security, or any asset accumulation scheme, is complete without emphasis on economic growth
- Most goods and practically all services can only be consumed when they are produced or shortly thereafter, so current consumption of goods and services cannot deviate greatly from current production for a long period
- Government policy can only change how the existing pie is sliced
- Any kind of savings can approach the status of “worthless IOUs” if the economy stagnates or declines
- Other things being equal, promoting economic growth is the best government policy for retirement security