COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET



# Let's Get Specific: Social Security
## September 2010

The *Let's Get Specific* series is intended to help focus the national discussion on specific policies that could help to reduce the deficit and create a better understanding of the types of policy changes that will be required. The policies recommended in this series are not necessarily endorsed by all the members of the Board of the Committee for a Responsible Federal Budget.

**Fig. 1: Summary of Recommendations**

| | **Savings** | | |
|---|---|---|---|
| | **10-Year ($Billions)** | **75-Year (% Payroll)** | **75th Year (% Payroll)** |
| Raise the early and normal retirement ages to 63 and 68, and index to longevity | n/a* | 0.5% | 1.2% |
| Use more accurate measure of inflation to calculate cost-of-living adjustments | $140 | 0.5% | 0.7% |
| Slow the growth of benefits for middle- and high-income earners | $25* | 1.2% | 2.9% |
| Institute additional protections including 1) a strong minimum benefit, 2) a "super-COLA" for disabled workers, and 3) an old-age benefit "bump-up" | -$15 | -0.2% | -0.4% |
| Institute revenue neutral reform of the payroll tax to make it more progressive | n/a | n/a | n/a |
| Establish mandatory add-on retirement accounts | n/a | n/a | n/a |
| **Total** | **$150** | **2.0%** | **4.4%** |
| ***Shortfall:*** | | ***1.9%*** | ***4.1%*** |

Note: Savings estimated and rounded, totals exclude interaction effects.
*Savings for these options would accrue largely outside the 10-year budget window.

In their most recent report, the Social Security Trustees warned—as they have in all recent years—that that the nation's public retirement system is on a path to insolvency. The program is running a cash flow deficit this year, and starting in 2015, it is projected to run cash deficits for every year in the future.

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The current recession has worsened Social Security's financial status (particularly in the short-term) by shrinking the tax base and pushing many people to collect benefits early (often through the disability program). However, the program's real problems are structural—the result of the now-retiring baby boom population and continued increases in life expectancy.

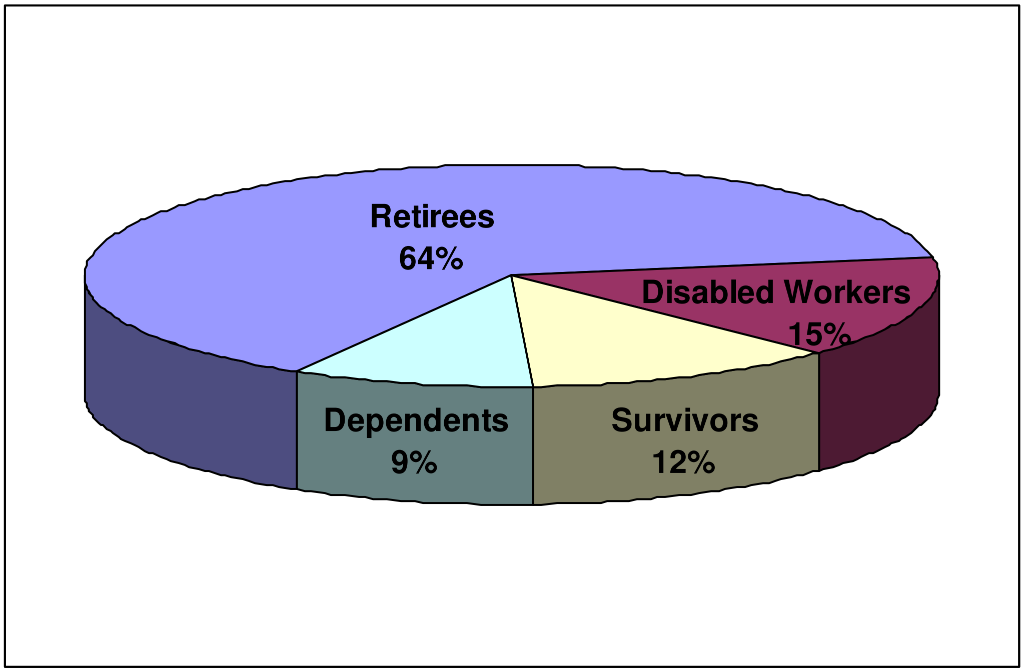
As a result, the program's outlays will grow by more than 1.2 percent of GDP (about 3.2 percent of payroll) by 2030, while revenues will fail to keep up, and will actually decline after 2020. Absent reform, these deficits will empty the program's statutory trust funds by 2037, resulting in an immediate 22 percent benefit cut for all beneficiaries. To avoid the benefit cut, Congress would be forced to transfer revenue from the general fund. Long before then, the program's cash shortfalls will begin to weigh heavily on the rest of the budget, driving up the amount the country needs to borrow. We need to act quickly to put the program on a sustainable path, and the longer we wait the more painful changes will be.

Yet Social Security reform cannot just be about solvency. We as a society are about to face a major demographic shift resulting in a much older population. This will drive up the costs of Medicare and Medicaid, reduce the number of taxpayers, decrease labor and capital (and therefore growth) in the economy, and put the retirement security of many people at risk.

In addressing these issues, it is critical to recognize how important Social Security is for so many people. In 2009, more than 52 million Americans received Social Security benefits, including nearly 8 million disabled workers, over 4 million widow(er)s, and more than 4 million children. For Social Security beneficiaries who are elderly, 52% of married couples and 72% of unmarried persons rely on Social Security for half or more of their income. Elderly Social Security beneficiaries—20% of married couples and about 41% of unmarried persons—rely on Social Security for 90% or more of their income.

Because so many people depend on the program, it is particularly important that changes be made as quickly as possible in order to spread them more equitably among the different groups that can afford changes and to allow more time for people to prepare.

**Fig. 2: Categories of OASDI Beneficiaries, 2009**




Our plan aims to address these issues by not only making Social Security solvent, but by encouraging longer working lives and more savings, and redirecting our scarce resources to where they are needed most.

We would do this by reducing benefits (especially by increasing the retirement ages) to make them affordable under the program's existing revenue stream, but then supplement these benefits with mandatory add-on accounts. These add-on accounts would allow individuals to pre-fund their own retirement, and over time they would generate enough to more than offset our benefit reductions for the vast majority of workers.

The plan would achieve sustainable solvency and would more than eliminate the program's 75-year actuarial shortfall of 1.92 percent of payroll. It also would more than close the 4.12 percent of payroll imbalance in the $75^{th}$ year. In addition, our plan would make the system more progressive, encourage more work, improve overall economic growth, and greatly enhance overall retirement security.

## Recommendations

**Raise the Retirement Age**

Many experts agree that, as life expectancy continues to rise, the Social Security retirement age should go up. Since 1930, the average life expectancy of a 20-year-old has increased by about a decade, from less than 70 to nearly 80. Yet the normal retirement age has only increased by a year, from 65 to 66 (it is scheduled to rise to 67 by 2027) and the earliest eligibility age actually has been reduced from 65 to 62.

We recommend that once the normal retirement age reaches 67, policymakers increase it two months a year until it reaches age 68. After that, we suggest indexing the retirement age to life expectancy—which is projected to be about one month every two years.

We also support increasing the earliest eligibility age in concert with the normal age so that it reaches 63 when the normal age reaches 68, and then grows with life expectancy thereafter. Note that raising the early age will have a negligible effect on solvency, since benefits are already adjusted downward for individuals who retire early, in order to keep lifetime benefits constant. However, the earliest eligibility age is probably the most powerful lever we have to encourage longer working lives, which is critically important to increase economic growth. In addition, failing to raise the early age will leave workers who retire at 62 with lower benefits throughout their entire retirement, which could cause real hardship for those who depend on Social Security.

There are legitimate concerns that raising the retirement ages will hurt those who simply cannot work past age 62, but would not qualify for disability insurance. We should first note that this makes up a minority of older workers—less than a fifth according to some estimates. It is much more sensible to reduce benefits at middle age, when the vast majority of individuals can still work and few have outlived their savings, than to reduce benefits for older retirees (which is effectively what not raising the early age would do). Still, to protect those who cannot work longer we recommend allowing withdrawals from add-on accounts (discussed later) beginning at age 62.

**Switch to Superlative CPI**

Currently, cost-of-living adjustments (COLAs) are calculated based on the consumer price index for urban wage earners (CPI-W), which many economists believe overstates price inflation because of something called substitution bias.

The CPI measures inflation by looking at the changes in prices of a "market basket of goods." However, when certain prices go up in that basket, consumers will tend to "substitute" less expensive goods. Though the CPI captures this substitution when it is within categories (for example, if consumers buy more Granny Smith apples when the price of Macintosh apples goes up), it does not capture substitution *between* categories (for example, if consumers buy more apples when banana prices go up). Fortunately, the Bureau of Labor Statistics calculates an alternative measure known as the chained CPI (sometimes called the superlative CPI,) to correct for this bias by reweighting goods based on consumption patterns. Because the chained CPI tends to grow about 0.3 percentage points more slowly than the regular CPI, it would substantially improve Social Security's finances.

**Slow Benefit Growth through Progressive Price Indexing**

To keep Social Security's costs under control, we believe it will be necessary to reduce the benefit formula to slow the growth of initial benefits. Though benefits could be slowed across the board, our preference is to focus benefit reductions on higher income earners and to protect those who rely on Social Security the most.

Under current law, Social Security benefits are derived by adjusting a worker's past wages forward, averaging them, and then applying a progressive formula—which is also adjusted for wage growth—to this average. As a result, initial benefits grow over time with wage growth.

We believe this makes sense for lower income earners who rely on Social Security, but is not affordable across the board. We thus recommend gradually adjusting the formula so that the highest income earners in the program will only see their initial benefits grow with prices, which generally grow at a slower pace than wages. In the policy world, this is known as progressive price indexing.

Under the form of progressive price indexing we recommend, the bottom 30 percent of earners would continue to see their benefits grow with wages, the highest earners would see their benefits grow with prices, and those in between would see a hybrid level of growth dependent on where in the income ladder they fell.

If allowed to continue forever, progressive price indexing would eventually completely flatten benefits so that all workers above the $30^{th}$ percentile would receive the same flat benefit. To prevent this, we recommend using the indexing formula only until mid-century, after which we would allow all initial benefits to again grow with wages.

**Increase Benefits for Vulnerable Populations**

In reforming Social Security, we must ensure it is fulfilling its basic mission to protect people from falling into poverty when they can no longer work. Currently, a lifetime minimum-wage worker would not receive large enough benefits to escape poverty. We recommend adding a new minimum benefit to Social Security, set at 100 percent of the poverty line for those who have worked for at least 25 years. This minimum benefit would increase with years worked, and with growth in wages in order to offer further protections over time. In addition, to protect those who may outlive their savings, we recommend a flat-dollar benefit enhancement for those who have reached age 85. This benefit increase could be phased in over a four or five year period to provide important protections for those who need them most. And finally, we recommend some type of benefits enhancement, perhaps through a "super COLA," for disabled workers. These individuals are the least able to rely on their work and savings, and we as a society must continue to make sure they are protected.

**Establish Add-on Retirement Accounts**

The provisions above will be more than sufficient to put Social Security on a sustainable long-term path, and to encourage longer work in the process. However, they will not enhance retirement security for most Americans, nor will they do enough to increase national savings and, therefore, investment.

To accomplish these goals, we recommend requiring individuals to contribute an additional 2 percent of their payroll—up to the taxable maximum—into individually owned retirement accounts. This additional savings would diversify individuals' retirement streams, help compensate for Social Security reductions, and add to net national savings.

Individuals would have the choice of directing their money into one of a few broad index funds, just as federal workers currently do with their Thrift Savings Plan. Those who do not make a choice will have their money automatically deposited into a life cycle fund which invests in higher-risk higher-return assets for younger individuals and safer but lower yielding returns for older workers.

These mandatory accounts would be the property of those who hold them, but funds could not be withdrawn or borrowed from before age 62, for any purpose. As a result, these accounts would accumulate significant assets over time—in most cases enough to more than offset the benefit reductions we have recommended above. Once they reach retirement, individuals could either undertake a scheduled or phased withdrawal from their accounts, or else purchase a retirement annuity.

One common concern with some private accounts is that they would replace traditional Social Security benefits with more risky investments, while significantly increasing the federal budget deficit. This concern relates only to so-called "carve-out" accounts which divert money from existing payroll taxes. Add-on accounts, such as we are recommending, would provide benefits *on top of* traditional benefits (albeit ones that are below what is currently promised due to Social Security's imbalances.) Not only would the account have no effect on the deficit, it would benefit the economy by contributing to higher national saving levels.

**Reform the Payroll Tax to Make it More Progressive**

Add-on accounts would represent a significant new burden to the lowest-income workers who may not be able to afford putting away an additional 2 percent of their income. To offset this effect, we recommend a payroll tax exclusion for workers equal to the minimum contribution necessary to qualify for Social Security—which comes to about $4,500 per year. We would pay for this by raising the current taxable maximum of $106,800 (indexed for wage growth) to the level necessary to ensure revenue-neutrality. We calculate this exclusion would have the effect of reducing total contributions (the payroll tax plus the add-on account) for those making under $28,000 a year, and increasing total contributions by only about 1 percent of payroll for someone making $56,000 a year.

## Other Possible Reform Options

The reform options outlined above are not intended to be an exhaustive list. The Social Security Administration and the Congressional Budget Office provide a long list of possible reforms. On the spending side, benefits could be adjusted across the board through pure price indexing, rather in the more progressive manner we suggest here. The benefit calculation could take into account more years worked. Or an additional bend point could be added to the benefit calculation. On the revenue side, the payroll tax cap could be eliminated, the payroll tax rate could be increased, and additional revenue sources could be dedicated to Social Security.

## Conclusion

Taken as a package, our plan would make Social Security sustainably solvent, encourage longer working lives, increase national savings, and protect those who depend on Social Security. In the process, it would not only help us to preserve the Social Security system, but also improve our overall fiscal situation and lead to enhanced economic growth. The problems facing Social Security have been known for a very long time; the sooner we start to make the necessary changes to the program, the easier they will be.