Social Security Reform

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Social Security and Retirement Income
Some Statistics: In March 2012…

- **Social Security is nearly universal**
  - 96% of Americans pay FICA taxes and/or receive benefits.

- **The number of people receiving benefits**….
  - Nearly 56 million beneficiaries received benefits last month – about 18% of the total population.

- **Average monthly benefit**….
  - …was $1,125. Nearly $63 billion was paid nationwide….

- In San Diego county, Social Security provides about $105 million to just under 100,000 beneficiaries/month.

- **Social Security prevents poverty among the elderly**….

  - The overall poverty rate in the United States is about 14%. However, for Americans age sixty-five and older the poverty rate is about 8.9%.

- Without Social Security, 44% of the recipients would be living below the poverty level.
To what extent does Social Security provide for retirement?

- “Replacement rate” measures retirement security…
- For a comfortable retirement, the average person needs a 70-80% replacement rate of the worker’s last year of earnings.
- However, Social Security on average has a 40-45% replacement rate of average monthly earnings (AIME).
- Some people rely too much on Social Security…
- Social Security is the majority of income for about half of all Social Security recipients. Social Security accounts for 90% of income for 43% of singles and 90% of income for 22% of married couples.
Most people are not prepared for retirement:

- People are not rational economic actors…
- Studies in Behavioral Economics shows that “visceral factors can lead individuals to choose the option that offers instant gratification” when the option is in close proximity.
- People don’t save enough for retirement…
  - They don’t participate in 401(k) or fund IRAs early enough or with enough money. They don’t have other savings.
- Many people retire at 62, thus reducing lifetime benefits.
- Recent financial downturns have affected net worth…
  - Portfolios have been decimated by downturns in the stock market.
  - The value of homes nationwide dropped on average 34% since March 2006. In San Diego, prices are down 40%.
Social Security Funding
How is Social Security funded?

• The “Pay As You Go” Model…
• The current incoming payroll tax immediately goes to pay current benefits.
• The current generation of working Americans pays the benefits of the retired generation.
• Any excess goes into a Trust Fund….
• When tax exceeds benefits, the excess goes into the trust fund (a rainy day, reserve fund).
• When the current payroll tax is not enough to fund current benefits, then the Social Security Administration taps into the reserves.
The Pay As You Go System is Broken

- The are fewer workers paying into the system and more beneficiaries...
- The Pay As You Go model only works if there is a high Worker to Beneficiary Ratio.
- From 1974 to 2008, the worker/beneficiary ratio was relatively stable between 3.2 and 3.4.
- In 2010, the ratio dropped to 2.9 workers per beneficiary and is projected to be at 2.1 by 2035.
- Declined caused by demographic, societal and economic changes...
What is the current state of the finances?

• The collective payroll tax is not enough to fund benefits …
• The Trust Fund has $2.5 trillion dollars invested solely in U.S. government bonds.
• The Trust Fund currently shows growth only through interest payments from the General Treasury.
• We pay out more in benefits than we take in from the payroll tax. In 2010 there was $544.8 billion in payroll tax revenue but over $577.3 billion in benefit payments.
• Unless only increase from this point forward.
• The Trust Fund will be exhausted by 2036…
• Non-interest income will pay about 75-77% of scheduled benefits. If we do nothing, then every beneficiary takes a 25% cut in 2036.
Reform Proposals & Voter Perceptions
Four Major Reform Proposals:

1. Raising the Retirement Age...
   - Benefit Cut for Future Retirees: Requiring people to work later into life reduces the lifetime benefit paid out.

2. Increase the Payroll Tax
   - Tax Increase for Present Workers: Expand the tax base to include high incomes.

3. Reducing Cost of Living Adjustments (COLA)...
   - Benefit Cut for All Retirees: Changing the way in which cost of living adjustments are made reduces costs.

4. Diversify the Trust Fund
   - Neutral: Diversify the Trust Fund assets from a government bond portfolio to include stocks, bonds and other assets to earn a higher rate of return.
Raising the Retirement Age:
Raising the Retirement Age: Overview

• One important factor in determining benefits is the age at which people start claiming.

• **Start at Early Eligibility Age at 62:**
  – Receive Partial Benefits

• **Start at Full Retirement Age at 65/66/67:**
  – Receive Full Benefits
  – Full Retirement Age is currently 66 for those born between 1943 and 1954.
  – 66-67 (gradual increase) for those born 1955 to 1960
  – 67 for anyone after 1960

• **Start after Full Retirement Age:**
  – Receive Enhanced Benefits
Raising the Retirement Age: Overview

- The majority of people start claiming benefits at 62.

- **Claiming Early reduces benefits FOR LIFE:**
  - Reduces benefits about 6.7% per year for the first three years below FRA.
  - Reduces about 5% for the each following year.

- **EXAMPLE:**
  - FRA is 66 and claim at 62
  - 25% reduction for life.
Raising the Retirement Age: Proposals

• **Increase FRA to 68 = 19% savings.**
  – After the full retirement age (FRA) reaches 67 for those age 62 in 2022, increase the FRA 2 months every year until the FRA reaches 68.

• **Increase FRA to 69 = 44% savings.**
  – After the full retirement age (FRA) reaches 67 for those age 62 in 2022, increase the FRA 2 months per year until it reaches 69 for individuals attaining age 62 in 2034. Thereafter, increase the FRA 1 month every 2 years.
Raising the Retirement Age: Proposals

- **Index FRA to Longevity = 20% savings.**
  - **Proposal:** After the full retirement age (FRA) reaches 67 for those age 62 in 2022, index the FRA to maintain a constant ratio of expected retirement years (life expectancy at FRA) to potential work years (FRA minus 20). We assume the FRA will increase 1 month every 2 years.
  - **Proponents:** Tries to roughly match increases in FRA for different cohorts to increases in longevity. Fairer in terms of generational equity.
Raising the Retirement Age: Arguments in Favor

- **Increasing Life Expectancy**
  - Since 1983, Men at 65 – up from 14.4 years to 17.2 years
  - Since 1983, Women at 65 – up from 18.6 to 19.9 years

- **Health among elderly has improved.**

- **Physically demanding jobs have decreased.**

- **Working longer has positive financial and health benefits.**
  - Save more money; Increases Social Security.
Raising the Retirement Age: Arguments Against

• Some *disenfranchised groups* have no choice but to retire early at 62.
  —*The poor, the less educated, those with health problems, and those who work in physically demanding jobs.*

• Not all socio-economic groups have seen the same increase in life expectancy.
  —*African Americans, the poor, the less educated, and blue collar workers—are affected disproportionally.*

• Older workers have more difficulty finding new employment
  —*When they do find employment, they often earn less than they did in previous jobs.*
Payroll Tax Proposals
Payroll Tax Proposals: Overview

• **Current Payroll tax -- FICA**

• Total of 12.4% on salaries up to $110,100 in 2012

• Employers pay 6.2%

• Employees normally pay 6.2%
  – Tax Holiday in 2011 and 2012 so that it’s only 4.2% for employees
  – Difference made up from General Budget – i.e. Income Tax.
  – **Query**: Is this tax holiday since it puts pressure on general budget.
Payroll Tax Proposals:

• Increase Tax rate from 12.4% to 14.8%
  – Restores solvency 100%. Adds slight surplus.
  – Primarily affects middle class workers – the people least able to pay

• Increase Taxable Maximum to include 90% of Earnings
  – Improves solvency by 37%.
  – Probably raises cap from $110k to $156k.
  – Assumes that benefits are paid out on new contributions.

• Eliminate Taxable Maximum Entirely
  – Improves solvency by 86%.
  – Assumes that benefits are paid out on new contributions.
Raising the Payroll Tax Cap: Pro and Con

- **Arguments in favor:**
  - During the 1983 reforms the taxable maximum included 90% of earnings. This would bring it back in line with historic norms.
  - Reform that has considerable support in polls of voters. NASI – 83%; Gallup – 67%; AARP – 57%
  - Higher tax will be partially offset by higher benefits.

- **Arguments against:**
  - Will increase costs for employers.
  - Creates disincentive for skilled people to work
Cost of Living Adjustments
Cost of Living Adjustments: Overview

• A retiree’s Social Security benefits are automatically increased by increases in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). Yet most economists agree that CPI-W over-compensates because of substitution. When the price of beef goes up, consumers substitute lower cost chicken.

• To solve this problem, BLS developed the Chained CPI-W – an index that takes into account that consumers substitute different goods when prices rise.

• C-CPI-U tries to take into account for the changes that people make in the composition of goods that they purchase over time, often in response to price changes. It is intended to capture consumers’ behavior as they respond to relative price changes.
**Cost of Living Adjustments: Overview**

- **Proposal**: Starting December 2012, compute the COLA using a chained version of the consumer price index for wage and salary workers (CPI-W).

- **Effect on Benefits**: Will reduce the annual COLA by about 0.3 percentage point, on average.

- Improves Solvency by 23%
Cost of Living Adjustments: Arguments in Favor

- Chained CPI is more accurate measure of inflation.
- Has a small effect on benefits.
- Proposal has support from both Democrats and Republicans and was one of the reforms endorsed by the Fiscal Commission.
- More fair. Spreads the benefit cut widely across all generations, unlike retirement age increases that target particular cohorts.
Cost of Living Adjustments: Arguments Against

• The elderly spend a greater percentage of budget on medical care than the general population.
  – Elderly spend about 11% of budget compared with the 5 to 6% spent by everyone else)
• Elderly also spend more housing, but less on categories like transportation apparel or education.
• **Counter-argument:**
  • Medical costs at 11% still represent a small percentage of overall expenses.
  • Healthcare costs could go down for elderly given health reform – e.g. reducing cost of prescription drugs.
  • Medicaid is available as a safety net for the truly poor.
Cost of Living Adjustments: CPI-E (Experimental)

• This would capture the price increases experienced by the elderly – i.e. increased health costs.

• Effect on Social Security:
  • SSA estimates that the CPI-E will rise about 0.2 percentage points faster than the CPI-W.
  • This increases Social Security benefits and makes deficit about 16% worse than it is already projected to be.
Diversifying the Trust Fund:
Diversifying the Trust Fund: Overview

- Invest 40% of Trust Fund in broad based market index instead of current investment of government bonds
- Assume nominal rate of return of about 8%
- Government bonds yield an annual nominal interest of 4.64%
- Improves long range actuarial balance by about 28%
Diversifying the Trust Fund: Arguments against

• Market is subject to large swings and Social Security is too important to take the risk of not funding benefits.
• American capitalism disfavors having the government as a shareholder in private enterprise.
• There is a danger in politicizing the investment.
Diversifying the Trust Fund: Arguments in favor

• Over the long term, the market returns about 8%.
• Achieves savings without cutting benefits or increasing taxes.
• Bonds are subject to inflation risk.
• Several public pensions funds exist and achieve market returns without the risk of political interference.
• Successful models exist in other countries – Canada, Norway and Australia.
5. Examples of SWFs as Prudent Investors.

- **Average Nominal Market Returns**: 7.9%
- **Risk Free Treasuries**: 4.6%

- **Examples of SWF Prudent Investors --Annualized Returns:**
  - *Norway Government Pension Fund-Global* -- 7.9%
  - *Canadian Pension Plan Investment Board* -- 5.9%
  - *New Zealand Superannuation Fund* – 7.83%

- **Example of Returns for Politicized Investment**
  - *Irish National Pension Reserve Fund* – 3.5%
When Will Change Occur?
Crisis Drives Change

• We lack the political will to change unless crisis creates the necessity for change. Bipartisan support necessary.

• In other countries, reform to Social Insurance occurred as the result of a funding crisis.
  – France and Canada are two examples

• The last big change in 1983 occurred as a result of a funding crisis. Politicians were motivated to find a solution by electorate.

• Most recently, the closest that we came was during the debt ceiling crisis in July-August 2011. Temporary agreement existed to raise the tax base and change COLA
Values Embodied in Social Security

- (1) Universal, or Nearly Universal, Coverage,
- (2) Earned Right,
- (3) Wage Related,
- (4) Contributory and Self-Financed,
- (5) Redistributive,
- (6) Not Means Tested,
- (7) Wage Indexed,
- (8) Inflation Protected,
- (9) Compulsory.

TENSION EXISTS IN SYSTEM: Attempts to balance between social adequacy (prevent poverty) and individual equity (benefit for everyone even the wealthy).
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