ISSUE GUIDE

A Guide to Analyzing Social Security Reform

American Academy of Actuaries

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PREFACE

The American Academy of Actuaries' Social Security Committee has written this guide for the general public, policymakers, and journalists, to use as they evaluate Social Security reform proposals. The Academy is a nonpartisan, nonprofit association with a mission to serve the public and the United States actuarial profession by providing independent and objective actuarial information, analysis, and education for the formation of sound public policy. The Academy and its Social Security Committee strongly believe Social Security is facing serious financial challenges that threaten the long-term sustainability of the program. Congress and the administration should take action sooner rather than later to address Social Security's fiscal sustainability and retirement security for current and future retirees.

INTRODUCTION

The Social Security Board of Trustees issues an annual report on the Old-Age and Survivors, Insurance and Federal Disability Insurance (OASDI) trust funds that provides a detailed assessment of the financial condition of Social Security program for the next 75 years. The 2012 trustees' report[1] shows that benefits and administrative expenses exceeded payroll tax income in 2012. That report projects that, based on the trustees' intermediate or "best estimate" assumptions, the deficits will continue indefinitely into the future. As a result, the Social Security trust funds that have been built up by past surpluses of taxes over expenses are projected to run out of money in 2033. Once the trust funds are depleted, benefit payments will be limited to what can be funded by tax revenues at that time.

The Academy's Social Security Committee has published a monograph entitled *Social Security Reform Options*, which provides a comprehensive overview of Social Security reform options, and a series of issue briefs analyzing recent and current proposals for reforming Social Security, including their impacts on benefits and solvency. This guide applies the concepts from these publications to proposed changes to the Social Security system that policymakers have raised and poses questions that should be asked of these policymakers on the topic of Social Security solvency. We encourage you to access these documents at http://www.actuary.org/briefs.asp#soc for a more in-depth analysis.

It is important to keep in mind that addressing Social Security's long-term financial challenges may involve a combination of changes from some or all of the types of reform presented in this guide. When evaluating proposals, be sure to consider the effect of any proposed changes to the Social Security program with respect to the program's projected deficit, the trust fund income and outgo, and the program's overall financial solvency. You also should consider how the changes will affect various demographic groups (i.e., women[2] compared with men, low income compared with high income, or young compared with elderly).

[1]The Social Security Committee publishes an annual issue brief on the trustees report. For more information, please read An Actuarial Perspective on the 2012 Social Security Trustees' Report (May 31, 2012) http://www.actuary.org/files/SSC_IssueBrief_2012TrusteesReport_120501.pdf

[2]For more information about how the Social Security program impacts women, please read Women and Social Security (July 2007 issue brief) http://www.actuary.org/pdf/socialsecurity/women_07.pdf

CHANGES TO FINANCING

Social Security is financed primarily by dedicated payroll taxes, 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 earnings base, that 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 U.S. Treasury securities and smaller amounts from other sources, such as income taxes levied on Social Security benefits.

According to the intermediate estimates in the 2012 trustees' report, current assets in the trust fund as well as future revenues are projected to fall short of future benefits and expenses during the next 75 years by $6.5 trillion on a present value basis, or approximately 0.9 percent of gross domestic product (GDP) on the same basis. This shortfall can be addressed by increasing the current payroll tax rate of 12.40 percent by 2.61 percentage points, to a rate of 15.01 percent—or through other taxation increases equal to 0.9 percent of GDP.

Questions to Ask When Evaluating Proposals to Change the Financing of Social Security

- Should the Social Security payroll tax rate be raised to strengthen system finances? If so, when?
- Should the Social Security payroll tax rate be indexed so that taxes increase automatically when projections indicate the system is inadequately financed?
- Should the Social Security payroll tax be graduated (according to income brackets) like income tax?
- Should general revenue, or revenue from another source such as a value-added tax,[3] be used to supplement the Social Security payroll tax?
- Should the Social Security taxable earnings base be increased beyond the level specified by the current indexing formula, or even eliminated altogether as with Medicare, so that all earnings are subject to the payroll tax?
- If all earnings were subject to the payroll tax, should all earnings also be used when calculating Social Security benefits? If all earnings are taxed but only earnings up to a limit are used to calculate benefits, would the program lose support among workers with earnings above that limit?
- Should a portion of trust fund assets be invested in asset classes other than Treasury securities with higher potential investment returns but greater investment risk?

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[3]A value-added tax is a form of consumption tax. From the perspective of the buyer, it is a tax on the purchase price. From that of the seller, it is a tax only on the "value added" to a product, material or service, from an accounting point of view, by this stage of its manufacture or distribution. The manufacturer remits to the government the difference between these two amounts, and retains the rest for themselves to offset the taxes they had previously paid on the inputs. http://en.wikipedia.org/wiki/Value_added_tax

CHANGES TO THE BENEFIT FORMULA

Social Security historically has provided benefits directly related to workers' earnings during their careers. The benefit formula[4] is indexed to wage inflation before age 62 and to the cost of living after age 62. Benefits calculated in the current Social Security formula replace a much higher portion of lifetime average earnings for lower-paid workers 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 of a worker whose earnings have always equaled the national average wage ($41,674 in 2010) is about 55–60 percent higher than for a worker whose earnings have always equaled the Social Security earnings base ($106,800 in 2010). This progressive benefit formula is the primary method through which the program addresses adequacy of benefits for workers with low earnings. Proposals that change the benefit formula or the cost-of-living adjustment also may affect the adequacy of benefits for workers with low earnings.

Questions to Ask When Evaluating Proposals That Change Social Security's Benefit Formula

- How would a proposed benefit 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?
- If benefit payments or cost-of-living adjustments were reduced when projections show the system is inadequately financed, how should those cuts be allocated?
- If savings come primarily from reducing benefits for high-income workers, would the program retain support among those workers?

[4] *Social Security Reform: Changes to the Benefit Formula and Taxation of Benefits* (June 2010 update) http://www.actuary.org/pdf/socialsecurity/Social_Security_Reform_Issue_Brief_6-15-10.pdf

CHANGES TO THE TAXATION OF BENEFITS

Annuities generally are included in income for tax purposes except for portions of the annuity that already have been taxed. Before 1984, 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 their Social Security benefit, exceeds a specified threshold, then a portion of the Social Security benefit is included in taxable income. That threshold is $25,000 for a single person and $32,000 for a married couple filing jointly, and the portion of the Social Security benefit included in taxable income could be up to 85 percent. 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; instead it is used to help finance Social Security and Medicare.

Questions to Ask When Evaluating Proposals That Change the Taxation of Social Security Benefits

- Should Social Security benefits continue to be taxed using the current formula? If not, should they be taxed like other forms of annuity income? Should the amount taxed be based on the specific history of taxable contributions made by each recipient?
- How would taxing benefits in this way affect the relative benefits of lower-paid workers versus higher-paid workers?
- If the current method for taxing benefits is retained, should the income thresholds be updated and/or indexed for inflation?
- 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?
- To what extent would changes to benefit taxation influence workers' retirement decisions?

One of the proposed Social Security reforms is a reduction or elimination of benefits for wealthier and/or higher-income participants and beneficiaries, and is generally referred to as *means testing*.[5] Advocates of means testing say 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. An underlying belief for those who support means testing is that government funds should not be used to aid those who are not in financial need.

Social Security benefits, on the other hand, currently are 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 creates the perception of an "earned right" to program benefits. Since Social Security's inception, the program has paid benefits to all retired workers who have worked in covered employment for a sufficient period, and to their family members and beneficiaries, without regard to income or wealth. Because the great majority of workers today are covered by Social Security, another important feature of Social Security is its universality. The principles of earned right and universality contribute to the program's broad popular support.

There are a number of philosophical and practical concerns associated with means testing. Of primary concern is the possible erosion of popular support for the system if the earned right and universality principles are modified or abandoned. Behavioral finance suggests that if the accumulation of savings for retirement were to reduce workers' Social Security benefits, workers may not save as much outside Social Security. Means testing could lead to the manipulation of income and assets to reduce the effect of testing, which would defeat the purpose while creating economic inefficiencies. It also would increase the administrative and compliance burdens associated with the Social Security program.

Questions to Ask When Evaluating Proposals for Means Testing

- Should means testing be based on income or assets, or both?
- How would income and/or assets be measured?
- How would the appropriate income and/or asset threshold for benefit reductions be determined?
- How would means testing be administered?
- Should Social Security be modified to resemble government safety net programs?
- Would this change in philosophy weaken public support for the program?
- Would direct savings from means testing be 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 that avoid direct means testing, such as changing the benefit formula or taxation of benefits, achieve similar results within the current program structure?

[5] Means Testing for Social Security (Dec. 2012; updates a 2004 issue brief) http://www.actuary.org/files/Means_Testing_SS_IB.pdf

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, the marked increase in longevity. Raising the retirement age further could improve significantly Social Security's financial status.[6, 7]

The cost of Social Security is increasing partly due to the fact that workers now are living longer, which means they receive benefits for a longer period. Since Social Security began paying monthly benefits, life expectancy at age 65 for both men and women has increased by about five years. Life expectancy is expected to increase by about five more years during the next 75 years according to the trustees' projections.

To further complicate this situation, studies[8] have shown that the average age of retirement in the United States decreased through the mid-1980s, though more recent studies appear to show that the average age is now increasing. 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 as deemed necessary, 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.

Workers are required by law 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 Ask When Evaluating Proposals That Raise the Retirement Age

- Do improvements in older workers' health and longevity justify increasing the age requirement for full benefits? Would this be true even if there were no projected shortfall?
- If workers must wait longer to receive full Social Security benefits, would jobs be available for them? Is the answer the same for men and women? For all income levels?
- Would raising the retirement age place a particular burden on workers in physically demanding occupations?

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[6] *Raising the Retirement Age for Social Security* (October 2010; updates an October 2002 issue brief) at http://www.actuary.org/pdf/socialsecurity/Social_Sec_Retirement_Age_IB_FINAL_10_7_10_2.pdf

[7] The Academy issued an advocacy statement in August 2008 in support of raising the Social Security retirement age. http://actuary.org/pdf/socialsecurity/statement_board_aug08.pdf

[8] http://www.tiaa-cref.org/institute/research/briefs/pb_earlyretirement0711.html

- 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?
- How would raising the retirement age affect Medicare and employer-sponsored health and retirement plans?

INDIVIDUAL ACCOUNT PROPOSALS

Social Security currently is a defined benefit program. This means that the contributions of all workers are pooled and available to pay benefits to any covered worker or family member. Some reform proposals include converting a portion of the system to a defined contribution program.[9] Under this type of program, workers would have individual accounts based directly on a worker's own contributions plus investment earnings, and funds would be available only to pay benefits to that particular worker and his or her family members. As employer-sponsored retirement plans are increasingly shifting from defined benefit to defined contribution type plans, some believe Social Security should move in the same direction. Others believe the shift toward defined contribution plans makes preserving Social Security as a defined benefit system even more important.

Individual 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). If the accounts have investment earnings above a specified target level, assets in the accounts at retirement could purchase annuity benefits sufficient to offset these reductions. Proponents of individual accounts say that this would allow the current level of benefits to be paid without raising taxes.

Questions to Ask When Evaluating Proposals for Individual Accounts

- Will an individual account proposal do a better job of providing retirement security than the guaranteed benefits in place under the current Social Security program?
- Would workers' individual accounts be mandatory or voluntary? If they are voluntary, how would the program protect itself from becoming an annuity program for low-income workers and an individual account program for high-income workers?
- How would the program protect (and pay for) benefits already earned, especially for current older workers and retirees?
- Would the program continue to provide a basic level of support for older workers and retirees who would not have an opportunity to build substantial account balances?
- What level of investment return would a worker need to achieve to receive the same benefits as under the current formula? What happens if investment returns are inadequate?
- If the current progressive formula is eliminated, 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?

[9] *Social Security Individual Accounts: Design Questions* (October 2003) http://www.actuary.org/pdf/socialsecurity/ssia_1003.pdf

- 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 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 and their own investments?
- How would those investment vehicles affect the relevant financial markets, and what is the likely affect on the value of current private (and public) investments?
- What type of oversight would there be for the investment alternatives to protect workers?
- Under what circumstances, if any, would workers be allowed access to their accounts before retirement?
- Would payout of benefits by lifetime annuities be mandatory or voluntary? If lifetime 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 are available on the Academy website at http://www.actuary.org/briefs.asp#soc.

Means Testing for Social Security (December 2012; updates a 2004 issue brief) http://www.actuary.org/files/Means_Testing_SS_IB.pdf

Understanding the Assumptions Used to Evaluate Social Security's Financial Condition (May 31, 2012) http://www.actuary.org/files/SSC_IssueBrief_Assumptions_120501.pdf

Significance of the Social Security Trust Funds (May 31, 2012) http://www.actuary.org/files/SSC_IssueBrief_TrustFund_120501.pdf

An Actuarial Perspective on the 2012 Social Security Trustees' Report (May 31, 2012) http://www.actuary.org/files/SSC_IssueBrief_2012TrusteesReport_120501.pdf

Automatic Adjustments to Maintain Social Security's Long-Range Actuarial Balance (August 2011; updates a 2002 issue brief) http://www.actuary.org/pdf/pension/IB_Auto_Adjustments_FINAL.pdf

Raising the Retirement Age for Social Security (October 2010; updates an October 2002 issue brief) http://www.actuary.org/pdf/socialsecurity/Social_Sec_Retirement_Age_IB_FINAL_10_7_10_2.pdf

Social Security Reform: Changes to the Benefit Formula and Taxation of Benefits (June 2010 update) http://www.actuary.org/pdf/socialsecurity/Social_Security_Reform_Issue_Brief_6-15-10.pdf

Academy recommendation to raise the Social Security retirement age (August 2008) http://actuary.org/pdf/socialsecurity/statement_board_aug08.pdf

Social Security: Evaluating the Structure for Basic Benefits (September 2007 issue brief) http://www.actuary.org/pdf/socialsecurity/structure_sept07.pdf

Women and Social Security (July 2007 issue brief) http://www.actuary.org/pdf/socialsecurity/women_07.pdf

Investing Social Security Assets in the Securities Markets (March 2007 issue brief) http://www.actuary.org/pdf/pension/sec_0307.pdf

Social Security Individual Accounts: Design Questions (October 2003) http://www.actuary.org/pdf/socialsecurity/ssia_1003.pdf

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