Commentary

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BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

Social Security Reform Proposals

In the December 2010 edition of *Commentary* we summarized the reform proposals of the National Commission on Fiscal Responsibility and Reform. These proposals were motivated by the objectives of achieving solvency and sustainability of the Social Security system. The Commission's objectives would be achieved through a number of parametric changes to the existing scheduled benefit and contributions arrangements, but without introducing structural change in the form of a system of individual accounts. To understand the perspective from which the Commission undertook its review of solvency and sustainability, it is important to stress that, although the Commission's mandate was primarily concerned with the national debt and budgetary deficits, Social Security does not contribute to the national debt since the Trust Funds do not borrow money to pay Social Security benefits. The Social Security system is projected to be more than 100 percent solvent until the year 2037, but thereafter would require increasing contributions or reducing scheduled benefits to extend the projected period of solvency. The latest report of the Social Security Trustees indicated that an increase in the payroll tax rate from its current level of 6.20 percent of covered payroll (for both employee and employer) to 7.16 percent would be required to extend the projected period of solvency to the year 2085. This 75-year projection period is established as one of the standard tests of the financial soundness of the system; however the trustees caution that there is an increasing degree of uncertainty about these projections as the length of the projection period is extended. Indeed, the population of 65-74 year old persons who will be receiving Social Security benefits in 2085 has not even been born yet; the 75-year projection exercise is based on an underlying hypothetical population projection exercise that involves a complex set of assumptions regarding future population growth, mortality and longevity. However, it is nevertheless evident that, based on the trustees' assumptions and probable trends, the current level of contributions of 6.20 percent of payroll will be inadequate to sustain the system fully beyond 2037. It has always been our view that, rather than focus exclusively on the actuarial estimates of the payroll tax rate necessary to maintain a 75-year projected balance between the values ascribed to the Social Security system's income and outgo streams, the economic cost of providing Social Security benefits should be expressed as a percentage of Gross Domestic Product (GDP). On this basis the economic cost of providing the existing scheduled benefits is projected to increase gradually from 6.00 percent of GDP currently to 8.13 percent of GDP by 2085; the aggregate projected deficit over 75 years is exactly 1.00 percent of GDP. We do not believe that a fixed payroll tax rate is a viable mechanism for financing this requirement and we advocate the adoption of an increasing scale for this rate so as to extend the projected solvency period beyond 2037. An annual increase of 0.05 percent in the payroll tax rate would be a feasible option to extend the solvency period and move toward long-term sustainability without reducing scheduled benefits.

By contrast, the recommendations of the National Commission involve very substantial reductions in future scheduled benefits while maintaining the concept of a fixed-rate payroll tax as the financing mechanism. The package of reforms proposed by the Commission would eliminate the projected 75-year imbalance and bring the hypothetical 75th year projections of income and outgo broadly into equal balance. In terms of extending the solvency period to 2085, the Commission would achieve this by implementing several major reforms. Together these reforms would reduce the projected shortfall over 75 years by 112% and reduce the 75th year shortfall by 102% thus more than compensating for the projected imbalances. However approximately one half of these reductions in the projected shortfalls would be accomplished by reducing basic benefits; in some cases there would be a 67 percent reduction in part of the primary benefit formula from 15 percent of earnings to just 5 percent of earnings. Another 26 percent of the reduction in the projected 75-year shortfall would be accomplished by reducing the automatic cost-of-living adjustment formula for benefits. The Commission's proposal for indexing normal retirement age to longevity would reduce the 75th year projected shortfall by 30 percent.

The Commission's focus on maintaining a fixed payroll tax rate and substantially reducing future benefits is too narrow and does not address the real issues of affordability and benefit adequacy. A debate is required on national old-age income provision consistent with social and economic needs. A doctrinaire focus on the concept of adhering to a fixed payroll tax rate as the financing method for Social Security's expected scheduled benefits, while shrinking the allocation of national resources available to the elderly population, is unjustified and counter-productive in a cohesive modern society.

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