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Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

Social Security Financing Policy Reconsidered

The US Social Security system of old-age, survivors and disability insurance (OASDI) is financed by a payroll tax as provided under the Federal Insurance Contributions Act (FICA). The excess of payroll tax receipts over the cost of benefits and administrative expenses is held in the Social Security Trust Fund and is invested in special issue Treasury bonds. In 2010 the payroll tax rate was 6.2% of covered payroll up to a maximum of $106,800 payable by both employee and employer. In 2011, as part of the government's economic stimulus program, the 6.2% rate is reduced by 2% to 4.2%; this is expected to be a temporary measure that will aid the economic recovery process. Over the 75-year history of the Social Security system, both the payroll tax rate and the maximum covered wage base, to which the FICA tax is applied, have increased from time to time. The Social Security system does not borrow money and does not contribute to the federal deficit; it is financed entirely by the FICA payroll taxes and the investment income received on the investments held in the Trust Fund. The assets of the Trust Fund exceed $2.5 trillion and are invested in a laddered bond portfolio with maturities of up to fifteen years with interest rates set at market rates at the time of issue.

The Social Security Trustees submit a report to Congress each year on the financial condition of the OASDI program that includes projections of expected income and outgo over a period of 75 years, based on best estimates of certain future economic and demographic factors. These projections disclose the extent of the adequacy or shortfall in the stream on income from FICA payroll taxes and investment income to meet the projected scheduled benefits payable under the current Social Security law. The results of the latest projections from the 2010 trustees' report disclose the solvency position, (as represented by the percentage ratio of the income and assets to the outgo), at 102% for 25 years, 92% for 50 years, and 89% for 75 years. 100% solvency for 50 or 75 years could be achieved by simply increasing the payroll tax rate. For example, 100% solvency could be achieved over the next 75 years by increasing the payroll tax rate to 7.1% from 6.2%. A lesser increase would achieve 100% solvency for the next 50 years. The trustees also publish the results of projections based on alternative sets of economic and demographic assumptions that serve to demonstrate the extent of the variation in the solvency position under both more favorable and more pessimistic future scenarios.

The fact that the FICA payroll tax rate and the maximum covered wage base to which it is applied have steadily increased over the years, suggests that, provided further increases are deemed affordable, the long-term solvency of the system could be achieved by moving the payroll tax rate to a higher level, either immediately or at some future point, or possibly by a system of small gradual increases, such as 0.05%, over a period of years. Although the FICA tax rate has been temporarily reduced in 2012 for economic stimulus purposes, the financial condition of the Social Security system will not be adversely affected, since the reduction will be counterbalanced by a comparable reimbursement from the Treasury. The FICA payroll tax rate is a flat rate applied to all covered wages up to a specified maximum. Some observers regard the flat tax rate as regressive and, as such, a source of hardship for individuals at the lower income levels. There is also a widespread belief that higher income earners above the maximum taxable limit should contribute their "fair share" to the Social Security system by means of applying the FICA rate to a part or all of income above the current maximum. Just as the Federal income tax system features a graduated scale of tax rates applied to all taxable income, there could conceptually be a graduated system of FICA tax rates to alleviate the effects of the present regressive flat rate system and to extend its application to higher income levels. A reconsideration of the FICA tax rate to move away from a flat rate system could readily achieve several desirable objectives, including ensuring long-term solvency and achieving "fair share" conditions for all contributors. There is also a potential opportunity to explore the introduction of a means for adjusting the FICA rate, either up or down, according to economic conditions from year to year, so as to reflect the cyclical effects of the "ability-to-pay" of employers and employees. While a flat rate FICA tax has always been in effect historically, and is administratively simple to apply, there are strong reasons now to advocate a greater flexibility in setting future FICA rates.

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