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Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

A View from the Treasury: Part Two

The U.S. Treasury has published the second in its series of Issue Briefs on Social Security. This second Issue Brief *Social Security Reform: A Framework for Analysis* seeks to present a top-down framework for designing and evaluating reform plans to address "the nature of the problem" as described in the first Treasury issue brief concerning the projected financial shortfall over the indefinite future or infinite horizon. It addresses four basic concepts: fairness across generations; fairness within generations; size of the safety net; and pre-funding future benefits. In this context, the use of the word "fairness" is somewhat controversial. In assessing the message that Treasury seeks to convey, it is important to remember that the original architects of the Social Security system adopted the two key concepts of "adequacy and equity" upon which to construct the basic design of benefits and contributions; these concepts of adequacy and equity unequivocally necessitated some element of cross-subsidy both across generations and within generations. Progressive policy advocates typically regard the concept of "fairness" as involving a sense of social solidarity and an emphasis on the "adequacy" component of Social Security.

The Treasury issue brief describes the *lifetime net benefit rate* as the present value of net lifetime Social Security benefits (benefits less taxes) as a percentage of the present value of the individual's lifetime wages; this metric is aggregated for all members of a birth cohort and is used to help assess the intergenerational "fairness" of policy reform options. The issue brief illustrates the effect of implementing hypothetical parametric reforms in terms of immediate and deferred payroll tax increases to achieve "permanent solvency" and concludes that waiting to reform Social Security with a payroll tax increase in 2041 puts a lighter burden on cohorts born prior to 2005 and a heavier burden on cohorts born after that year when compared to the effect of imposing an immediate payroll tax increase. Treasury confirms by this analysis the conventional wisdom that the smaller the reform burden imposed on early birth cohorts, the larger must be the burden placed on later cohorts. The issue brief next addresses how to distribute what it calls "the burden of reform" within birth cohorts. It accepts the established practice and belief that it is reasonable to expect that this burden will be apportioned in a progressive fashion and notes that progressivity can be achieved in a number of ways including, as at present, with a progressive benefit formula, but, in principle, could be achieved by means of varying payroll tax rates in a progressive fashion on a graduated scale. The results presented in the Treasury analysis are informative in terms of providing a quantitative analysis of the progressivity feature. The issue brief is very clear concerning the impact of the limit on covered earnings for applying the payroll tax rate in stating: "while the current-law Social Security program is progressive overall, it is regressive (as measured by the net benefit rate) for income levels that exceed the maximum taxable earnings threshold."

The Treasury issue brief discusses the question of how large should Social Security's benefits be in terms of what role Social Security should play in providing retirement security and how much choice individuals should have in making their saving and spending decisions. The issue brief contrasts the view that higher benefits and taxes protect workers from the consequence of their failing to save with the alternative view that individuals should be allowed to choose to save or spend their earnings as they wish with a resulting preference for lower Social Security benefits and taxes. In this context the issue brief makes an important point in stating: "The retirement benefit paid by Social Security is a real annuity; that is, it is paid out as long as the retiree is alive and is indexed to inflation once benefits commence with retirement. Because of the program's relatively low administrative costs and inflation-indexation provisions, and because forcing nearly all workers to participate eliminates the adverse selection problems that affect private annuities, it is likely that Social Security can transform a given amount of forced saving into a more generous real annuity than could a private company." The issue brief continues with illustrations of benefit adequacy in terms of a benefit replacement rate metric that is the ratio of benefits to the amount of retirement income that would be needed to sustain a person's living standard while working.

The February edition of *Commentary* will continue the review and discussion of the Treasury's second issue brief including the key question posed by the Treasury: "Is attempted pre-funding real?" This next edition will also review the most recent third Treasury Issue Brief *Social Security Reform: Benchmarks for Assessing Fairness and Benefit Adequacy.* Previous editions of *Commentary* are available at www.buffinpartners.com/archives

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