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Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

Social Security Update on Solvency and Sustainability

Encouraging reports appeared recently regarding the stability of the Social Security system and its long-term sustainability. The 2004 Trustees' Report confirms that the system remains 100% solvent with respect to benefits payable through 2042. Based on the trustees' intermediate level projections, the system is 108% solvent for the next 25 years, 93% solvent for 50 years and 88% solvent for 75 years. On the basis of the trustees' alternative low-cost projections, the system is more than 100% solvent for 75 years. In order to achieve 100% solvency over 75 years on the intermediate basis and retain a buffer fund equal to one year's benefits and costs, the system requires additional funding equivalent to 1.89% of covered payroll. On the trustees' alternative low-cost projection basis, the system is in surplus over 75 years by an amount of 0.41% of covered payroll. Although the trustees qualify their report on the long-range projections by explaining that the results are inherently less reliable as the projection period is extended, nevertheless the long-term sustainability of the system is often assessed in terms of the magnitude of the projected increase in the payroll tax rate necessary to restore 100% solvency over the full 75-year period. However, the emerging economic and demographic experience over the next 75 years could make the 1.89% projected deficit subject to a wide degree of estimation error.

A timely study published by Brookings Institution addresses the particular problem of restoring full solvency over the next 75 years by making adjustments to the Social Security program sufficient to mitigate the deficit of 1.89% of covered payroll. The authors of the study, economists Peter Orszag and Peter Diamond have undertaken an objective academic analysis of the Social Security system and have developed specific proposals for achieving long-term balance and sustainable solvency. The Orszag-Diamond proposals also address issues of social adequacy and equity. These proposals aim to preserve the essential structure of the Social Security system through a strategy of moderate revenue and benefit adjustments, while strengthening benefit provisions for widows and lower-wage earners and protecting disability and survivor benefits.

The Orszag-Diamond proposals introduce reforms in four separate categories that, in aggregate, would improve the 75-year financial projections to eliminate the projected deficit and achieve a sustainable position beyond 75 years. In the first proposal, recognition of increasing life expectancy would result in benefit reductions worth 0.26% of payroll, and increase payroll tax revenue by 0.29%. In the second proposal, adjustments for increased earnings inequality above and below the maximum taxable wage base, would raise the limit on taxable earnings, generating an additional 0.25%. Reduced benefits for higher earners would be worth an additional 0.18%. In the third proposal, the legacy cost of the program arising from its initial design features, that granted benefits to workers that exceeded the value of their contributions, would produce the greatest contribution to restoring solvency. Imposing a legacy tax on earnings over the maximum would reduce the deficit by 0.55%; and imposing a legacy charge on benefits and revenue would produce an additional deficit reduction of 0.97%. Making Social Security coverage universal would reduce the deficit by 0.19%. Improvements to enhance the adequacy of certain benefits would add 0.43% to the deficit, and an adjustment to reflect the interaction of the various proposals would add 0.26%.

The Orszag-Diamond proposals do not require general revenue financing and do not introduce individual accounts. Given a choice between other proposed reforms of Social Security and the Orszag-Diamond proposals as a means of addressing the long-term projected deficit and sustainability issues, we favor the Orszag-Diamond proposals as a specific plan for consideration by Washington policymakers.

One of the great challenges for today's professional pension advisers is the revitalization of the private sector defined benefit pension system. Over-regulation, accounting, funding and tax problems, abandonment of corporate responsibility and competition from defined contribution arrangements have all been identified as forces contributing to the demise of defined benefit plans. In a recent Washington colloquium with our professional colleagues, we appealed for consideration of a mandatory second-tier earnings-related pension benefit under Social Security, applicable to all employed persons, with a proviso that any privately sponsored defined benefit pension plan could elect to "contract-out" of the second-tier arrangement if it provides at least equivalent pension benefits, in effect providing for full privatization of this part of Social Security. The present Social Security benefit formula applies benefit factors of 90%, 32% and 15% to index-adjusted earnings in three bands delineated by two "bend-points." A second tier system would extend the 32% and 15% benefit percentages to perhaps 60% and 40% to provide, in aggregate, an acceptable national target level of retirement income for all employed persons.

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