Commentary

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Social Security Reform Options

The American Academy of Actuaries has published a Public Policy Monograph *Social Security Reform Options*; this monograph presents an in-depth analysis of each of the principal potential reforms to the US Social Security system. The stated objective of the monograph is to provide policymakers and the general public with essential information relating to technical and policy-related issues on Social Security reform. The monograph addresses the financial challenges of maintaining the solvency and sustainability of the system and the likely effects of each type of reform option, but without advocating any particular viewpoint. The introduction provides a general overview and discusses the concepts of social adequacy and individual equity as the fundamental characteristics of the system and refers to its financial viability as measured by the official 75-year projections of income and expenses. The financial status of Social Security is summarized in terms of three key dates: 2017 when outgo for benefits and administrative expenses are first expected to exceed tax income; 2027 when outgo is first projected to exceed total income including investment income; and 2040 when all the previously accumulated assets will have been dispersed to pay full benefits leaving a projected imbalance between future income and outgo unless reforms are made to the system. The magnitude of the financial challenge is reflected in the projected increase in the cost of Social Security benefits from 4.3 percent of GDP currently to 6.3 percent of GDP 75 years from now. The Academy's monograph presents analyses and discussions of potential reforms in three broad categories: changes within the current structure; other alternatives within a defined benefit structure; and individual accounts.

In the first category, the monograph addresses the topics of increasing the retirement age, introducing tax changes, including increasing the payroll tax, increasing the limit on taxable earnings, increasing the taxation of benefits, and expanding coverage under the system to include individuals not presently covered by Social Security. The current payroll tax rate is 6.2 percent, payable by both employers and employees. About 85 percent of earnings in covered employment are below the 2007 limit on taxable earnings of $97,500. Removing the limit for taxes on both employers and employees, but retaining the limit for calculating benefits, would eliminate the long-range actuarial deficit; removing the limit both for taxes and calculating benefits would eliminate most, but not quite all of the deficit. If no changes are made to the limit on taxable earnings or benefits, the payroll tax rate could be increased from 6.2 percent to 7.21 percent in order to meet the projected 75-year deficit. As an alternative to increasing taxes, the projected 75-year deficit could be met by reducing future benefits; a benefit cut of about 13 percent for all future benefits would restore the 75-year solvency of the system, but, based on the official Social Security projections, would not be sufficient to sustain the solvency position beyond 75 years. The Academy's monograph explores a number of potential ways of adjusting the various components of the basic benefit formula to achieve reductions in the level of future benefits, including the percentages applied to each of three bands of the earnings used in the benefit formula, and the manner in which career earnings history is currently revalued by indexing to changes in the national average wage level. Possible changes to the formula for cost-of-living adjustments to benefits in payment are also discussed in the monograph.

In the second category, the monograph considers the investment of assets held by the Social Security system, the concept of means testing, and explores the possibility of utilizing general revenue financing. Investing 40 percent of assets in equities, phased in over 15 years, would reduce the 75-year deficit by about 40 percent, assuming a 6.5 percent real rate of return over the long term. Means testing could be applied to reduce or eliminate benefit payments otherwise payable where income or assets exceed specified thresholds. Many social insurance programs in other countries receive some financing from general treasury funds, and that approach could be adopted for the US Social Security system, by directing a part of income tax revenues to support the program. Alternatively, new non-payroll-based taxes, such as a value-added tax could be earmarked for the program.

In the third category, a major part of the monograph is devoted to a discussion of individual accounts, including types of design, the implications for the concepts of individual equity, social adequacy and earned rights, and the important issue of financing, including transition costs. This section of the monograph also reviews the question of voluntary or mandatory individual accounts, the challenges of managing the accumulation and investment of funds, and the need during the payout phase to provide lifetime income and withstand the risks of longevity, investment markets and inflation, by means of annuitization.

Buffin Partners Inc.

P.O. Box 1255
Sparta, NJ 07871
Phone: (973) 579-6371
Fax: (973) 579-7067
Email: commentary@buffinpartners.com