Fixing Social Security: A CED Policy Update

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An Update of a Policy Statement by the Committee for Economic Development's Research and Policy Committee

THE PURPOSE OF THIS UPDATE

At the President's urging, the first and most prominent item on the legislative agenda for this year is Social Security reform. Social Security is of vital importance both in its own right, and because it has substantial impact on the nation's overall fiscal policy. CED is concerned today that a misguided approach to Social Security restructuring might not only endanger the accomplishments of that program, but also miss an important opportunity to turn the nation's fiscal policy back in the right direction. Such an approach could even do still further damage to our financial standing at home and in the international marketplace. In short, Social Security legislation could make or break the nation's essential safety net, and the budget.

CED issued a report, *Fixing Social Security*, in 1997, and we believe that the principles and policy recommendations are as pertinent today as they were then. This brief statement explains why that proposal remains highly relevant today, in terms of both fiscal policy and retirement policy.

INTRODUCTION

Like most Americans, we believe that Social Security, more formally known as Federal Old-Age, Survivors and Disability Insurance (OASDI), is one of the most successful social programs in U.S. history. The basic objective of Social Security—to protect the economic security of retirees—is sound, and the nation must not falter in its commitment to it. Social Security also provides an important safety net for survivors of younger workers, and for the disabled, saving their families from severe financial distress. It provides financial security for those who live very long lives, with inflation protection that is virtually impossible to obtain from the private sector. The decline in poverty rates for the elderly is strong evidence of the overall beneficial effects of this program. Social Security fulfills all of these functions at minuscule administrative cost. These virtues must be preserved through any proposed reform.

Still, because of the challenge posed by the aging of the U.S. population, substantial change in the Social Security system is inevitable. When the baby-boom generation begins to retire, the system's current operating surplus will begin to decline, after which the trust fund balances will be drawn down at a rapid rate. If no action is taken, the system will be forced to impose a very large, inequitable and economically inefficient increase in the tax burden on future workers, and/or sharp and disruptive cuts in benefits, in an approximate range of from 2018 (the time when Social Security tax revenues fall short of benefits, according to the Social Security actuary) to 2052 (when the Social Security Trust Fund is exhausted, according to the Congressional Budget Office). But the problems of the system should not be exaggerated; under current economic and demographic assumptions, and with no additional sources of revenue, Social Security can continue to pay somewhere in an estimated range of from about 73 percent (according to the Social Security actuary) to about 78 percent (according to the Congressional Budget Office) of currently promised benefits in perpetuity.

CRITERIA FOR REFORM

Given the Social Security funding shortfall, reform will be a collection of unpleasant steps, chosen to minimize the overall pain. Even in instances where the goal of reform is to improve some aspect (such as the balance of relative benefits across generations) of the current system, progress will be constrained by the actuarial deficit in the system. Agreement on the fundamental objectives of Social Security and its relation to the broader issue of national retirement policy would help the nation to spread the discomfort fairly across the population.

Considering the important role that Social Security plays in our society, CED recommends the following criteria for evaluating proposed changes in the system.

- Social Security should provide a minimum retirement income—that is, a safety net—for all workers and their families. The lack of an adequate retirement foundation would result in hardship among the population (especially those with persistent low incomes or who suffer economic setbacks), and persuasive demands for relief through other federal, state, and local programs, which would be less equitable, more administratively costly, and demeaning to the elderly.
- The Social Security benefit structure should retain an element of progressivity, whereby the ratio of benefits to contributions is higher for lower-income workers.
- Participation in the Social Security system by workers should be universal, because the burden of supporting the redistribution and insurance elements of Social Security should be shared as broadly as possible.
- Social Security reform should strive for greater equity between generations and for better returns on contributions than the present system will provide for future retirees. When the program's funding runs short a few decades from now, future workers and retirees will face higher taxes or lower benefits, or both; and some privatization plans would in effect burden those workers with funding both their own retirements and those of the baby-

boom generation. Hiding such burdens through massive borrowing would do those younger and future workers no favor. Timely reform should aim to minimize this inequity through increased saving and investment, and also through higher returns for younger and future workers.

- Reform should also seek greater equity among current participants, particularly between workers with nonworking spouses and other retirees.
- A fundamental objective of Social Security reform is to increase national saving, so that the burden of supporting rising numbers of elderly is made less onerous by more rapid capital accumulation and economic growth.
- Social Security reform should not derail the critical economic objective of eliminating deficits in the federal budget. With deficits far too large and with prospects for sufficient improvement dim, Social Security reforms should reduce, not increase, deficits and borrowing in the coming years. (CED also advocated improvements in the federal budget process to ensure that these budget savings are protected, and not immediately spent. See *Exploding Deficits, Declining Growth: The Federal Budget and the Aging of America*, Committee for Economic Development, March 2003.)
- Reform measures should minimize disincentives for labor force participation by the elderly, and encourage private saving.
- Changes that have a continuing positive effect on the system's actuarial balance and provide automatic responses to changed circumstances (such as a larger-than-anticipated increase in life expectancy) are preferable to one-time changes that merely postpone insolvency.
- Reform measures should be administratively feasible, should not raise administrative costs significantly, and every effort should be made to minimize costs arising from investments in private assets.
- Changes in Social Security benefits should be enacted promptly and phased in gradually. Those in or close to retirement must be protected. Current workers need reasonably accurate information concerning expected Social Security income in order to make informed decisions about retirement saving and retirement age, and they require adequate lead time to plan and adjust their behavior to any changes in the system.

Of course, no reform proposal can fully satisfy all these criteria, because there are unavoidable tradeoffs. For example, cuts in benefits would be likely to increase both public and private saving, but would also reduce the economic security of retirees.

To balance these tradeoffs, CED believes that Social Security should be divided into two components: (1) a defined benefit that includes both a safety net for low-income and disabled workers and survivors, and insurance against the loss of retirement income; and (2) a mandatory personal retirement account (PRA), which provides retirement benefits from contributions accumulated in the account. Such a dual system would satisfy most of the reform criteria favored by CED, as explained below.

SUMMARY OF POLICY RECOMMENDATIONS
Reforming the Existing System

With respect to the existing defined benefit, the CED reform program would gradually phase in changes in the Social Security system and thereby avoid serious disruptions in labor markets and in the lives of retirees. It would protect the economic security of lower-income retirees, and over time further reduce poverty among the elderly. It would achieve the fairest possible balance of burdens across generations. Present retirees and older workers would experience little or no change in benefits from the existing system (though the portion of benefits subject to taxation would rise for some). The particular policy steps enumerated below would both eliminate Social Security's 75-year actuarial shortfall, and reduce inequities between retired married couples with non-working spouses and other retirees.

- **Reduce the Growth in Initial Benefits.** CED's plan would reduce the system's costs by gradually reducing initial benefits for new upper- and middle-income retirees, but not for low-wage workers. (This step would have no effect on current retirees). Technically speaking, the most direct and equitable way gradually to trim the growth of prospective benefits is to reduce the growth in the primary insurance amount (PIA), which is the first-year benefit received by an individual who retires at the normal retirement age (NRA). CED's plan would gradually reduce replacement rates for the two higher-wage brackets in the PIA formula, thereby reducing the growth of future benefits in the existing defined benefit program for middle- and upper-income participants, but not for low-wage workers.

  The growth of initial benefits would be reduced further by increasing the number of years of wages included in the PIA formula from 35 to 40 years. Currently, those who contribute for only 35 years are eligible for benefits as high as for those who contribute for a longer period.

- **Reduce the Growth in Lifetime Benefits by Raising the Normal Retirement Age.** The normal retirement age long remained at 65, without adjustment to compensate for the large increase in life spans in the last half century. This raised the cost of Social Security dramatically. In 1983, Congress enacted legislation providing for a gradual increase in the NRA to 67, which only partially offsets the rise in average life spans. To further compensate for past and expected increases in life expectancy, CED's plan would raise the normal retirement age by two months per year until it reaches 70 years. Thereafter, the NRA would rise in line with increases in life expectancy. The earliest eligibility age, currently 62 years, would be increased to 65 over the same period and subsequently similarly indexed.

- **Tax Social Security Benefits.** CED recommends that the income tax apply to all Social Security benefits in excess of the contributions made by the worker. (This result would be approximated by taxing 85 percent of benefits for all workers. Taxation of benefits derived from a worker's own contributions would constitute double taxation.) With this change, Social Security would be taxed like other contributory programs. Low-income recipients would not be affected because they are exempted from income taxation through the personal exemption that is available to all potential taxpayers, and a special higher standard deduction for the elderly.

- **Reduce Spousal Benefits.** At present, a spouse is entitled to a retirement benefit equal to his or her own benefit or 50 percent of the other spouse's benefit, whichever is higher. Consequently, the rate of return on contributions is much higher for couples with a nonworking spouse than for others. To reduce costs and to improve equity between working and nonworking spouses, CED recommends that retirement benefits for the nonworking partner of a retired couple be reduced gradually until they reach 33 percent of the worker's PIA. CED does not recommend any reduction in the non-worker's survivor benefits, which may be as high as 100 percent of the worker's PIA.

- **Expand Coverage to Include State and Local Employees.** The Social Security system redistributes income from high-income retirees to low-income retirees. CED favors continuation of a redistribution element in the Social Security program. However, CED believes that as a matter of equity, the burden of redistribution must be widely shared, and therefore that coverage should be universal. Consequently, CED recommends that all new state and local employees be required to become participants in the Social Security system, and that current employees be permitted to join Social Security on a voluntary basis.

The CED proposal builds in a margin for projection error. The policy proposals were selected in 1997 to over-achieve 75-year solvency for the program, with a safety margin of more than one third of the then-measured deficit. Thus, enactment of the CED reforms could result in a substantial long-run surplus in the retirement program. Consequently, if experience confirms this projection, it may eventually be possible to terminate the phase-in of further cuts in benefits, or to reduce payroll tax contributions.

The Second Tier: Personal Retirement Accounts

CED believes that all employees and employers should be required to contribute to personal retirement accounts (PRAs). CED believes that the PRA system should be an "add-on" to the current system. Payroll tax revenues should not be "carved out" and contributed to private accounts, because existing payroll taxes are needed to finance benefits even under the reformed and newly solvent Social Security program, which would maintain the basic safety net. We believe that so-called "carve out" proposals, which divert payroll taxes to private accounts, would increase the budget deficit dangerously.

The PRAs favored by CED would have the following characteristics:

- PRAs would be funded by mandatory contributions totaling 3.0 percent of covered payroll, with payments split equally between employees and employers. (The self-employed would contribute the entire 3.0 percent of covered payroll.)
- PRAs would be owned by individuals and directed by them. Contributions could be invested only in a limited number of broad-based funds that hold private-sector financial securities.
- Contributions to PRAs would receive tax-preferred treatment similar to that accorded to 401(k)s. Individual and employer contributions would be made from before-tax income, and earnings would accumulate on a tax-deferred basis. Individuals would pay taxes only on future benefits derived from PRAs.
- The accumulated balances in PRAs would be part of the estates of deceased workers in the event of death before retirement.
- We recognize that some mandated business participants and their employees, as well as many self-employed, do not have hands-on experience with retirement saving accounts. Therefore, to protect these groups, special rules for PRAs will be needed to assure appropriate communications, prudent investment alternatives, reasonable fees, and preservation of funds for retirement. In providing appropriate safeguards for PRAs, maximum use should be made of existing regulations governing private pensions and 401(k) and IRA saving plans (revised as needed) to minimize the need for new regulatory or supervisory bodies.
- To assure that PRAs would be used for their specific intended purpose—to provide retirement income for the full lifetimes of the participant and spouse—CED favors rules applicable to PRAs that (1) prohibit withdrawals or borrowing of PRA funds before retirement, and (2) ensure that funds are withdrawn gradually over the life of the participant after retirement. (This would occur, for example, if PRA fund balances were annuitized at retirement.) Employers that already manage pension funds for their employees may find it necessary to create separate "side-car" accounts for PRA contributions to comply with the additional restrictions applicable only to PRAs.

The PRAs would also generate a sizable increase in private (and national) saving. Of course, some individuals and businesses will finance contributions to PRAs by reducing present contributions to private pensions, 401(k)s, etc. To the extent that this form of substitution occurs, there will be less increase in private saving, labor costs will be unaffected by PRA contributions, and retirement saving created by PRAs will be partially offset. Moreover, if tax-sheltered PRAs are substituted for saving that is not entitled to tax preference, federal revenues would be reduced, thereby offsetting some of the improvement in private saving. However, a large number of workers, including most contingent and part-time workers, are not currently covered by discretionary employer retirement plans, and many workers have little or no personal savings to shift into the new PRAs. For those with little or no saving, the creation of mandatory PRAs will undoubtedly generate a large increase in saving. Furthermore, for some, the experience of owning such assets may encourage additional saving.

The creation of PRAs will help to restore the confidence of young people in the Social Security system by offering an opportunity for a higher return on contributions and giving workers a sense of ownership. Although contributions to PRAs would be mandatory and, in many cases, would raise business costs, these contributions should not be considered taxes because no revenue is received by any government agency and the funds are personally owned and privately invested.

CED acknowledges that the requirement for compulsory savings will be difficult for workers at the lowest income levels. However, the alternatives of increased payroll tax rates while still employed or inadequate benefits while retired would be totally unacceptable.

CONCLUSION

Thus, the CED plan would create a two-tier system: (1) a fiscally balanced basic benefit—that is, the present "defined benefit" program with spending growth cut sufficiently to make the system sustainable; and (2) a new "defined contribution" program that would involve mandatory contributions to PRAs. If this two-tier system is enacted promptly, the economic safety net now provided by Social Security can be preserved without overburdening future workers. The economic well being of low-income retirees would be protected because most of the benefit reductions in the current system (though not the increase in the retirement age) would be limited to middle- and upper-income participants. PRAs, which would provide an additional source of retirement income for all retirees, would be particularly valuable for those whose benefits from the defined benefit system are cut. Intergenerational equity would be improved by increasing the importance of benefits derived from a funded system, and by offering an opportunity for younger people to receive adequate investment returns on their contributions. This CED plan provides a retirement saving program for workers not covered by a retirement plan, including part-time and contingent workers who frequently do not have access to private retirement programs.

Finally, and importantly, the CED program would generate a substantial increase in national saving that would help to boost long-term economic growth and thereby make it easier for the nation to support the growing elderly population. Without such reform, the nation will confront the very unpleasant choice of a substantial reduction in the economic status of the elderly or an economically damaging and unfair burden on future generations of workers. In contrast, most of the proposals for converting Social Security to a privatized pension pay for at least a part of the transition costs by increased federal borrowing. With deficits already too large and the beginning of the retirement of the baby-boom generation just three years away, such a strategy would seem risky in the extreme.

In sum, CED's approach to Social Security reform would seem more in tune with widely accepted principles of social cohesion and fiscal prudence. We urge policymakers to consider this alternative. ■

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