4.16 RESEARCH BRIEF

Reforming Social Security

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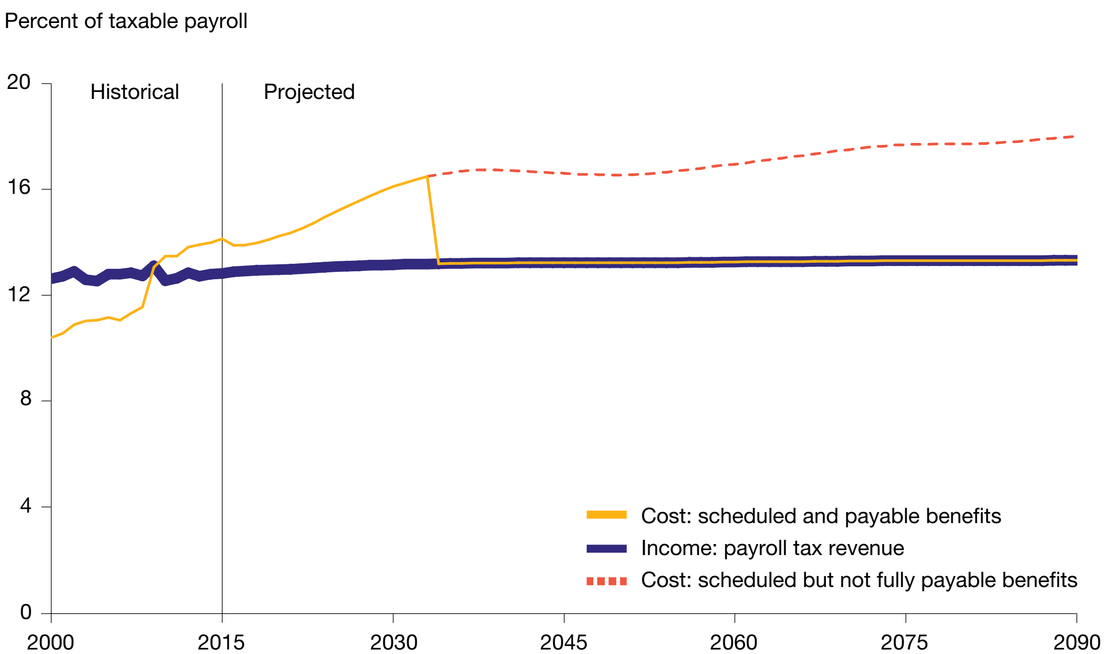
April 15 is income tax filing day, but the biggest tax most people pay during the year is Social Security.

Since its enactment in 1935, Social Security has become an important feature of the retirement landscape for all Americans. But its finances are in need of repair. Despite the significant taxes already paid into the Social Security system, future benefit payments are expected to both outrun future tax revenues and consume any accumulated surplus (Chart 1).

Reforming Social Security is a complex and often emotional topic. Any reform will adversely affect some groups while helping others. Nevertheless, some reform is needed in the next few years or Social Security will start imposing a significant burden on the federal budget. Every option for reform has opposition, but it still should be possible to create a package of reforms that would fix the finances of Social Security.

Chart 1. Payroll tax revenue will cover only 79% of Social Security benefits by 2034.



Payable benefits as percent of scheduled benefits

2014–2033	100%
2034	79%
2089	73%

Source: 2015 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds; intermediate assumptions.

Packaging reforms

One example of a possible package of reforms: Raise the cap on taxable earnings (closes about 30 percent of the program's financial gap), gradually raise the retirement age (closes about 25 percent of the gap), change the indexation of benefits to the chained Consumer Price Index (closes 10 percent of the gap), and raise payroll taxes 1 percent, split between employers and employees (closes the gap about 35 percent).

The advantage of the package approach is that the burden of adjustment is spread among all societal groups. In the above example, those who are working and are far from retirement age would face decades of higher payroll taxes, and taxes would be much higher for high earners, because the taxable cap would be raised. Those who are close to retirement would not pay the higher payroll taxes for much longer, but they would have to accept a higher retirement age. And current Social Security beneficiaries would see lower cost-of-living adjustments in the future.

When the burden of reform is spread so that no one group appears to benefit at the expense of others, the chances increase for reform being adopted. If reform encompasses several changes, each change can be made less drastic, making it possible for the people affected to adjust more easily. As we explore the pros and cons of ways to raise revenue or curtail benefits, we can see the value of packaging the options.

Social Security's wide impact

The reliance of America's elderly on Social Security for income cannot be overstated. Simply put, the majority of them rely on it for most of their retirement income. Nearly one in four married beneficiaries and one in two single beneficiaries get at least 90 percent of their income from Social Security. Any reduction in benefits would adversely affect these people and would have subsequent spillover effects on the rest of society.

Social Security benefits are not trivial but also are not large enough to make anyone extremely well off. Let's say both spouses of a married couple each made $25,000 a year. Under the current formula, their expected benefit at age 65 would be about $20,400, or $10,200 per person. The federal poverty level for a family of two is $16,020, so benefits would keep this married couple slightly above the poverty threshold.

If nothing changes in the Social Security system by 2034 when the cushion provided by its trust fund runs out, tax revenue will be able to pay only about 79 percent of promised benefits. Unless the laws governing Social Security are changed by then, benefits will have to be cut across the board to match the payroll tax revenue available at the time. In our example couple with a benefit of $20,400, this would mean a benefits cut to $16,116, on par with the official poverty line.

How benefits are calculated

Before we dive into how the system could become financially stable, it is important to understand the basics about how it is financed and how benefits are calculated. (More details on how Social Security works are presented in AIER's "What You Need to Know about Social Security," https://www.aier.org/research/what-you-need-know-about-social-security. Specific information about your own benefits is available from the Social Security Administration website at www.ssa.gov or your local Social Security office.)

Any worker who pays into the system for at least 40 quarters (10 years) earns a benefit. Worker benefits are based on average earnings over the top 35 earnings years. In other words, if you work for 40 years, the benefit is calculated based on only the 35 years of your highest earnings. However, if you only work for 20 years, your "average" earnings will be reduced by including 15 years of zero earnings. Taxes apply to labor income. Other forms of income, such as capital gains or rental income, are not taxed by Social Security.

However, not all labor income counts—SSA sets a maximum taxable income. In 2016, the maximum is $118,500 (it is adjusted every year by the increase in the average wage index).

The size of benefits is derived from average earnings through a complicated formula designed to make benefits progressive. For example, someone with average pre-retirement earnings of $24,000 a year would receive a benefit of about $13,640, while someone with average pre-retirement earnings of $60,000 a year would get about $25,160—a much lower income replacement ratio.

Once a person reaches Social Security's definition of full retirement age, he or she is entitled to receive 100 percent of the calculated benefit. Claiming benefits before full retirement age reduces them, and delaying claiming past full retirement raises them. The full retirement age is currently 66 for people born between 1943 and 1954, and it is scheduled to gradually rise to age 67 for people born in 1960 or later. If a person claims benefits at 62, Social Security's early retirement age, he or she would receive only 70 to 75 percent of the full benefits.

If a person delays claiming beyond the full retirement age, his or her benefits increase by 8 percent for each year that retirement is delayed up to age 70. For a worker born in 1950 with a full retirement age of 66, delaying benefits until age 70 would result in a 32 percent increase (8 percent times four years). This is why delaying claiming benefits, if at all possible, is usually suggested as a prudent financial tactic. (For more information, visit our AIER blog, https://www.aier.org/blog/why-its-so-hard-delay-social-security.)

Benefits are indexed to inflation based on the Consumer Price Index for Wage Earners and Clerical Workers (CPI-W). These annual cost-of-living adjustments allow elderly beneficiaries to maintain purchasing power in an inflationary environment. In years when inflation is negative (prices fall), the cost-of-living adjustment is set to zero, as it was in 2016, based on 2015 prices.

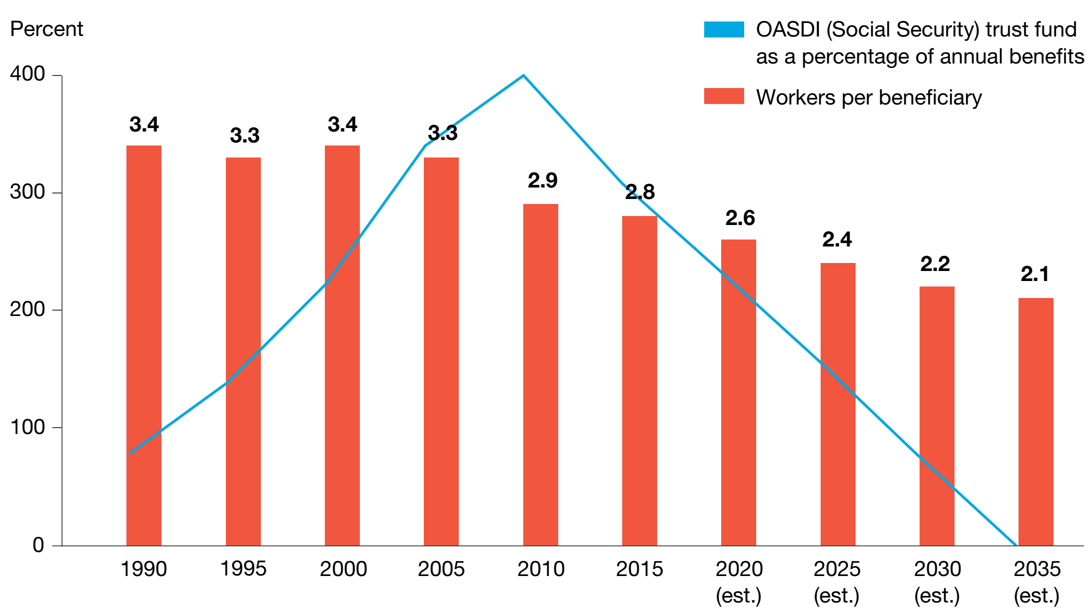
How Social Security is financed

Social Security is funded from payroll taxes. The current tax rate is 12.4 percent—6.2 percent paid by the employee and 6.2 percent paid by the employer.

During 2015, the Social Security system took in $827 billion (excluding interest income) and spent $897 billion on current beneficiaries. This meant the program's net cash flow was a negative $70 billion. This shortfall was covered by interest income of about $90 billion earned on the assets in the Social Security trust fund. The trust fund was created when, in the past, taxes paid into Social Security exceeded payouts to current beneficiaries. It has grown over time and currently amounts to about $2.8 trillion, a cushion large enough to pay benefits for about three years without any additional revenue.

However, unless changes are made, the trust fund is about to start dwindling and will be exhausted in 2034 (Chart 2). The problem is a demographic one. In 1960, there were 5.1 workers for every Social Security beneficiary. By 1990, that ratio had fallen to 3.4 workers for every beneficiary—still sustainable. By 2010, there were only 2.9 workers for every beneficiary, and the program

Chart 2. Currently 2.8 workers pay Social Security taxes for every one beneficiary. As the beneficiary population grows, that ratio will drop to 2.1 workers per beneficiary by 2035. Social Security trust fund revenues are depleting, too.



Source: SSA 2015 OASDI Trustees Report.

started running a deficit. The problem is worsening, and by 2030 we are expected to have only about 2.2 workers per beneficiary.

Ways to raise revenue

Increase the payroll tax

An increase of 2.7 percent, split between employer and employee, would cover the 75-year financing shortfall for Social Security. An increase in taxes is politically difficult and may have negative economic consequences, but it may be the simplest solution.

Raising the payroll tax would not be unprecedented. When the Social Security system began collecting taxes in 1937, the rate was only 2 percent, 1 percent each for the employer and employee. By 1960, the rate had increased to 6 percent. Over the next three decades, the payroll tax gradually increased to its current rate of 12.4 percent by 1990.

Economic theory suggests that increased taxes can slow economic growth by discouraging work, but in practice, the magnitude of this effect is difficult to determine. We know that a payroll tax increase would have a greater impact on those with lower earnings, because while benefits are progressive, the Social Security payroll tax is not—everyone pays the same tax rate. Nonetheless, an increase in the tax rate is a feasible option for reform. If we made changes today, a 2.7 percent payroll tax hike (split between employee and employer) would cover the 75-year financing horizon. If we wait until the trust fund is exhausted in 2034, a hike of more than 4 percent would be required to cover benefits at the current level.

Raise the cap

Social Security's taxable maximum of $118,500 a year, or "cap," is indexed to the national average wage index. In the 1950s and 1960s when the cap was much lower, less than 80 percent of all wages were taxed by Social Security. Over time the cap was raised, and by 1983, about 90 percent of covered wages were taxable. Since then it has fallen to around 83 percent.

Some have called for raising the cap to a level that would again cover 90 percent of earnings (currently this would be about $275,000). In a 2012 survey, 68 percent of respondents favored raising or eliminating the earnings cap in order to increase revenue, while only 8 percent opposed it (24 percent were not sure).

Increasing the taxable maximum seems to be an easy way to raise revenue, and it would affect only highly paid workers, who arguably are better able to withstand the increase. Only about 6 percent of workers make more than the cap in any given year. According to AARP and the National Academy of Social Insurance, raising the cap to about $275,000 would solve about 29 percent of the 75-year funding gap.

Those who oppose raising the cap argue that higher taxes would discourage some workers from earning above the cap, although there is little empirical evidence that the economy would stall as a result of such an incremental change. The other problem with this option is that it affects the upper middle class much more than it does the truly wealthy, who would still pay Social Security on only a small share of earnings.

This has caused many to call for eliminating the earnings cap. That would solve about 70 percent of the 75-year shortfall. But eliminating the cap would also create a powerful incentive to convert compensation into non-wage forms, which are not taxed by Social Security. Since the wealthy have access to many more ways of doing so than the upper-middle class, eliminating the cap will not bring as much additional revenue as one might think. This problem, in theory, could be solved by applying the Social Security tax to all forms of income (e.g., capital gains, interest income, rental income, and the like), not just wages. This, however, would represent a massive tax increase on these forms of income, and it is highly unlikely that such a large tax increase would be adopted.

Ways to cut benefits

Across-the-board cut

The most obvious, and perhaps the most severe, strategy for reducing Social Security outlays is an across-the-board benefits cut. If enacted immediately, the cuts would need to be about 16.4 percent if applied to all current and future beneficiaries, or 19.6 percent if reductions are applied only to those who retired in 2015 or later, according to the Social Security trustees. If we wait until the trust fund is exhausted, the cuts would be made automatically and would be larger—probably about 20 to 25 percent applied to all beneficiaries.

Such a cut would affect all retirees, but low-income, non-white, and older households—those most reliant on the system—would see the highest proportional income cut. It is unlikely that Congress could ever get enough support for such a drastic benefit cut.

Raise the retirement age

One popular strategy for reducing Social Security outlays is to increase the full retirement age. This has already been done once, from age 65 to 66, and another increase, to 67, is on the way. People argue that the full retirement age should be raised because the average life expectancy of Americans is rising. In effect, people are receiving more lifetime benefits by virtue of living longer than previous beneficiaries. An average 65-year-old female in 1950 could expect to live another 16.2 years. By 2011, the average female could expect to live 20.2 years longer. Life expectancy should continue to increase with advances in health care, meaning that Social Security will have to pay more and more beneficiaries into their late 80s, 90s, and even 100s.

One proposal calls for raising the retirement age from 67 in 2023 to 70 in 2069 – a gradual increase that most beneficiaries could conceivably plan for. The early retirement age would also gradually increase from 62 to 65, while delayed retirement credits would be eliminated. This gradual increase would fill an estimated 26 percent of the 75-year funding gap.

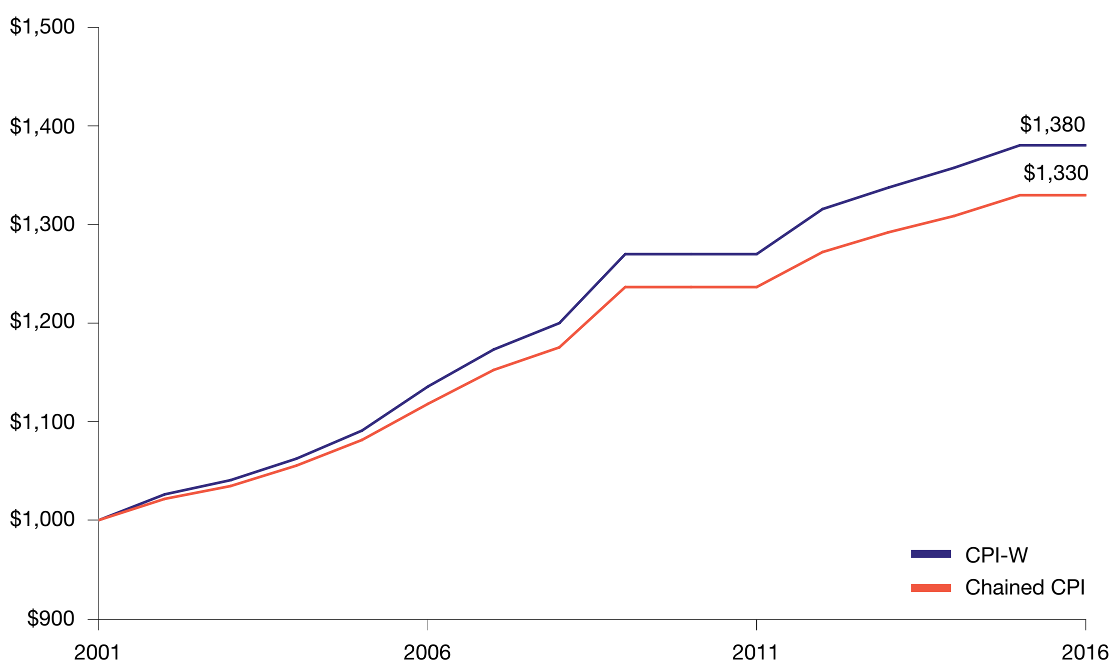
There is a fair amount of pushback to this idea. There is evidence that people retire early because of poor health, and this is more common among lower-income and blue-collar workers, who are also most likely to rely on Social Security for most of their retirement income. For people who are unable to postpone their benefits claims, an increase in Social Security's full retirement age essentially translates into a reduction in benefits.

Change the way benefits are indexed

Policy makers and economists have argued that the CPI-W does not accurately reflect changes in the cost of living. Some have proposed using a different index for computing Social Security's cost-of-living adjustment—the chained CPI, which accounts for people purchasing lower-cost alternatives in response to rising prices. Using the chained CPI would reduce cost-of-living adjustments.

This was proposed in 2010 by the Bowles-Simpson deficit reduction commission and by President Barack Obama (neither proposal was adopted). Had benefit indexation been based on the chained CPI for the past 15

Chart 3. Indexing benefits to the chained CPI would reduce cost-of-living adjustments and lower benefit payments, as this example shows.



Source: Bureau of Labor Statistics, AIER.

years, Social Security benefits in 2016 would be about 3.7 percent lower than under the current indexation rules (see Chart 3, previous page). This may seem like a small difference, but it would matter to the low-income retirees who depend most on Social Security.

If recent history is a guide to the savings that can be achieved by switching to the chained CPI, such a measure would close around 10 percent of the funding gap. But if future inflation is significantly lower that it has been in the past, the savings would be even smaller, as the difference between the chained CPI and CPI-W diminishes when inflation slows.

Benefits means testing

The argument for this option is that Social Security benefits should be given to those who truly need them and may be reduced or eliminated for people who have other means of financing their retirement. A version of such means testing already exists. Starting in 1983, Social Security benefits, which had previously been untaxed, became subject to federal income taxes for retirees with high enough income from other sources. Retirees with other income (including wages, interest, dividends and the like) that exceeds $25,000 for single taxpayers and $32,000 for those filing jointly need to pay federal income tax on a portion of their Social Security benefits. This in effect discourages people who receive Social Security from seeking other sources of income, for example, by continuing to work, or from saving aggressively prior to retirement to provide substantial interest and dividend income once retired. This, in turn, reduces the tax revenue Social Security could have collected from their wages. Any proposal that expands means testing would have a similar adverse incentive effect.

Another problem with means testing is the effect on public perception. One of the reasons for Social Security's broad popularity is the perception that everyone participates. If the inclusive nature of the program is altered by means testing, so that only those who are "in need of help" receive benefits, broad support for Social Security may be eroded.

A package of reforms

Our review of the options to remedy Social Security's financial shortfall shows how difficult this could be. The best chance of successful reform may well be a package of changes that ease the adverse effects on any one group. If nothing changes, the trust fund will run out in 2034, and demographic shifts will reduce the tax revenue available to pay benefits to a growing elderly population. Every option to change this presents winners and losers, but a package of pragmatic solutions has the best chance of legislative success.

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