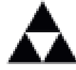
Election 2004:

A Guide to
Analyzing the Issues

The Questions Candidates Should Answer about ...

Social Security Reform

American Academy *of* Actuaries



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Preface

This guide has been written by members of the American Academy of Actuaries' Social Insurance Committee for journalists, policy-makers, and citizens to use as they evaluate the candidates' proposals during the 2004 election cycle. The Academy is a non-partisan, non-profit professional association. While neither the Academy nor its members specifically endorse or oppose any of the reforms discussed in this guide, they strongly believe that it is imperative that Congress and the administration take action to reform Social Security, and that action is needed sooner rather than later.

Introduction

Each year the board of trustees of the Social Security program* issues a report about the program's financial condition. In great detail, the trustees' report presents its assessment of the financial condition of Social Security for the next 75 years. The 2003 trustees' report shows that, based on the trustees' intermediate ("best estimate") assumptions, benefits and administrative expenses are projected to exceed payroll tax income in 2018; and the Social Security trust funds are projected to run out of money in 2042, after which benefit payments must be limited to what can be funded by the payroll tax.

The Academy previously published a series of issue briefs analyzing proposals for reforming Social Security and the impact such proposals would have on the benefits that workers and family members would receive and on the solvency of the system. This guide summarizes several of these issue briefs and suggests questions that should be considered when analyzing any proposed changes to the Social Security system. We encourage you to access our issue briefs at **www.actuary.org** for a more in-depth analysis than we provide here.

**Officially the Old-Age, Survivors and Disability Insurance (OASDI) Trust Funds.*

Financing

Social Security is financed primarily by a dedicated payroll tax shared equally, in most circumstances, by covered workers and their employers. The tax is a flat percentage of earnings up to a maximum amount, called the Social Security wage base, which is indexed each year to increases in the national average wage. Social Security also receives interest income from the investment of trust fund assets in government bonds.

According to the intermediate estimates in the 2003 trustees' report, the current tax rate of 12.40 percent will have to be raised by 1.92 percent, to 14.32 percent, to support the estimated benefit payments and administrative expenses for the 75-year projection period in the report.

Questions to consider when analyzing a candidate's proposal to change the financing of Social Security:

- Do improvements in living standards justify an increase in the Social Security tax rate to strengthen system finances?
- Should the Social Security tax rate be indexed in some way so that taxes increase automatically when projections show the system is inadequately financed?
- Should the Social Security tax be graduated like income tax, or would this risk the loss of support among high-income workers?
- Should the wage base be increased beyond the current indexing formula, or even eliminated altogether as in Medicare, so that all earnings are subject to the payroll tax? If so, would the newly taxed earnings be included in earnings for calculating Social Security benefits?
- Should general revenue be used to supplement the Social Security payroll tax?
- Should a portion of trust fund assets be invested in securities other than government bonds with potentially higher investment returns?

Changes to the Benefit Formula

Historically, Social Security has provided benefits related to workers' earnings during their careers. The benefit formula is indexed to wage inflation before retirement, and to the cost of living after retirement. Benefits calculated in the current Social Security formula replace a much higher portion of lifetime average earnings for lower-paid than for higher-paid workers. For example, the replacement rate (i.e., the percentage of a worker's pre-retirement earnings that is replaced by Social Security) at normal retirement age (age 65) is about twice as high for a worker whose career earnings average 45 percent of the national average wage than for a worker whose earnings always have equaled the Social Security wage base. This progressive benefit formula is the primary method through which the program addresses adequacy of benefits for workers with low earnings.

Questions to consider when analyzing a candidate's proposal for changes to Social Security's benefit formula:

- How would a proposed change affect the standard of living during retirement for workers and their family members at different income levels?
- How would a proposed change affect the standard of living for disabled workers and beneficiaries of deceased workers at different income levels?
- How would a proposed change affect the benefits of divorced spouses?
- Would a proposed change affect men and women differently?
- If savings come primarily from reducing benefits for high-income workers, would the program retain support among those workers?
- Would it be acceptable to make benefit changes contingent on system finances so benefits decrease, or do not increase as rapidly, when projections show the system is inadequately financed?

Changes to the Taxation of Benefits

In general, annuities are included in income for tax purposes except for any portions that already have been taxed. Before 1983, no portion of a recipient's Social Security benefits was included in income for tax purposes. Today, if a recipient's adjusted gross income, plus non-taxable interest income, plus one-half of the Social Security benefit, exceeds a specified threshold, then a portion, up to 85 percent, of the Social Security benefit is included in taxable income. This threshold is $25,000 for a single person and $32,000 for a married couple filing jointly. Unlike most dollar thresholds in Social Security and income tax formulas, these are not indexed to take into account changes in average wages or the cost of living. Additional revenue from taxation of Social Security benefits does not go into the federal government's general fund like other income tax receipts. It is used to help finance Social Security and Medicare.

...a portion, up to 85 percent, of the Social Security benefit is included in taxable income.

Questions to consider when analyzing a candidate's proposal for changes to the taxation of Social Security benefits:

- Should Social Security benefits be taxed like other forms of annuity income?
- If not, should the current income thresholds, for determining what portion of a recipient's benefit is subject to taxation, be updated and/or indexed for inflation?
- Would changes in the taxation of Social Security benefits affect how retired workers time their receipt of other retirement benefits? For example, might such changes discourage annuitization of personal savings?
- Should revenue from the taxation of Social Security benefits continue to be split between Social Security and Medicare, go entirely to Social Security, or go to the federal government's general fund like other income tax receipts?

Means Testing

Among proposed Social Security reforms is the reduction or elimination of benefits for wealthy and/or high-income participants and beneficiaries, generally characterized as "means testing." Advocates of means testing note that reducing or eliminating benefits for those whose income or assets exceed certain thresholds would reduce Social Security's financial deficit while helping to preserve Social Security as a safety net for those who truly need it. Underlying means testing is the principle that government-sponsored programs should be targeted at lower-income segments of the population and that government funds should not be used to aid those not in financial need.

On the other hand, Social Security benefits are currently based on an employee's covered wages. This link between the wages that have been taxed during a worker's career, and the benefits the worker receives after retirement establishes, an "earned right" in the minds of program participants, which is part of the foundation of the program's popular support. Since Social Security's inception, the program has paid benefits to all workers who have worked in covered employment for a sufficient period, and to their family members and beneficiaries, without regard to wealth. This universality reinforces the idea of Social Security as an earned right.

> *This link between the wages that have been taxed during a worker's career, and the benefits the worker receives after retirement establishes an "earned right" in the minds of program participants, which is part of the foundation of the program's popular support.*

There are a number of concerns associated with means testing. Of primary concern is the potential erosion of popular support for the system if the earned right principle is modified or abandoned. Further, if workers saving for retirement find that such savings could reduce their Social Security benefit, they may not save as much. Additionally, because means testing could encourage people to hide their assets and

income in order to avoid the effects of the means test, complex rules would be needed to make these actions illegal.

Questions to consider when analyzing a candidate's proposal for means testing:

- Should Social Security be modified to resemble a more traditional government welfare program?
- Would such a change in philosophy weaken public support for the program?
- Should means testing be based on income or assets, or both?
- How would the proposal measure income and/or assets?
- How does the proposal determine the appropriate income and/or asset threshold for benefit reductions?
- How would means testing be administered?
- Would direct savings from means testing be largely offset by indirect costs, such as reduced incentives to work or save for retirement, legal or illegal avoidance of benefit reductions, and increased administrative costs?
- Could alternatives, such as changing the benefit formula or taxation of benefits, achieve similar results within the current program structure?

Raising the Retirement Age

When the Social Security program began paying monthly benefits in 1940, workers could receive unreduced benefits beginning at age 65 — the normal retirement age (NRA). The law was changed in 1983 to increase the NRA gradually, beginning in 2000 from age 65 to age 67, recognizing at least in part that longevity had increased greatly. Raising the retirement age further could significantly improve Social Security's financial status.

The financial problems of Social Security are partly due to workers living longer now than they did in the past and receiving benefits for a longer period of time. Since Social Security began paying monthly benefits, life expectancy at age 65 has increased four years for men and six years for women. Moreover, the trustees anticipate further significant increases in life expectancy during the 75-year projection period.

The financial problems of Social Security are partly due to workers living longer now than they did in the past and receiving benefits for a longer period of time.

To further complicate this situation, studies have shown that the average age of retirement in the United States decreased through the mid-1980s. The combination of living longer and retiring earlier means that Social Security must pay benefits for a longer period of time, while payroll taxes are collected for a shorter period.

Proposals calling for an increased retirement age include: ad hoc increases to the NRA; indexing the NRA to keep the average benefit payment period the same; indexing the NRA to keep the ratio of retirement years to working years the same; and adjusting the NRA as necessary to maintain actuarial balance. Present law requires workers to wait until the early eligibility age, currently 62, to receive benefits, which are reduced for retirement before the NRA. Some proposals would raise the early eligibility age in addition to the NRA.

Questions to consider when analyzing a candidate's proposal for raising the retirement age:

- If workers must work longer to receive full Social Security benefits, would jobs be available for them? Is the answer the same for men and women?
- Do improvements in older workers' health and longevity justify delaying the age requirement for full benefits?
- To what extent would cost savings be offset by additional disability benefits?
- How would raising the normal retirement age for workers affect the benefits of family members?
- If the age requirement for full benefits is increased, should the early eligibility age be increased as well?
- How would Medicare and employer-sponsored retirement plans be affected by raising the retirement age?

Individual Account Proposals

Many recent Social Security proposals call for American workers to accumulate all or a portion of their payroll taxes in individual accounts to fund their retirement income. Proponents of this approach seek greater returns in the investment markets by giving workers direct control and ownership of their accounts. Opponents are concerned about reducing Social Security's guaranteed benefits and diverting payroll taxes that would otherwise be used for paying current benefits.

The current system is a defined benefit social insurance program in which the contributions of all workers are pooled and available to pay benefits to any worker or any worker's family members. Individual account balances are based directly on a worker's contributions, plus investment earnings, and are available only to pay benefits to that particular worker and his or her family members.

The current system is a defined benefit social insurance program in which an individual's benefits are only indirectly related to his or her total contributions. The contributions of all workers are pooled and available to pay benefits to any worker or any worker's family members. In contrast, individual account balances are based directly on a worker's contributions, plus investment earnings, and are available only to pay benefits to that particular worker and his or her family members.

Questions to consider when analyzing a candidate's proposal for individual accounts:

- Would workers' individual accounts be mandatory or voluntary?
- Would individual accounts be added to the current program, or would they replace all or a portion of the current program?
- How would the program grandfather benefits for older workers and retirees?

- Would the program continue to provide a basic level of support for older workers and retirees?

- Would higher-income workers subsidize the accounts of lower-income workers? If so, how would this subsidy affect support for the program among higher-income workers? If not, how will the program address the possibility that benefits would be inadequate for lower-income workers?

- Would the program reduce benefits for disabled workers and survivors?

- Would individual account funds be shared upon divorce?

- Would the transition to individual accounts require financing from general revenue? If so, how much?

- Would individual accounts be managed and invested centrally, or would workers be allowed to choose their own investment managers?

- How many investment alternatives would workers be offered, and what would they be?

- How would workers be educated to make informed investment decisions?

- Would workers be allowed access to their accounts before retirement?

- How much would record keeping, investment management, worker education, and other services associated with individual accounts cost, and how would they be financed?

- Would small accounts have proportionately larger expenses, or would they be subsidized?

- Would payout of benefits by lifetime annuities be mandatory or voluntary? If annuities are voluntary, how will the program address the risk that employees who do not elect annuities will outlive (or outspend) their retirement accounts? How would payout annuities be designed, priced, and administered?

Public Statements on Social Security by the American Academy of Actuaries

*The following publications, as well as additional documents, are available on the Academy website on **www.actuary.org/socsec/index.htm**, or can be ordered by contacting the Academy directly (see page 2).*

2004

Social Adequacy and Individual Equity in Social Security (January 2004; updates a 1998 issue brief)

"Assumptions Used to Project Social Security's Financial Condition," (January 2004, updates a 2001 issue brief)

"Means Testing for Social Security," (January 2004; updates a 1996 issue brief)

2003

"Social Security Individual Accounts: Design Questions," (October 2003, updates an earlier version)

"An Actuarial Perspective on the 2003 Social Security Trustees Report," (April 2003 issue brief, updated annually)

2002

"Social Security Benefits: Changes to the Benefit Formula and Taxation," (October 2002; annually updated issue brief)

"Raising the Retirement Age for Social Security," (October 2002, updates a February 2001 issue brief)

"Social Security Reform: Voluntary or Mandatory Individual Accounts?," (September 2002 issue brief)

"Automatic Adjustments to Maintain Social Security's Long-Range Actuarial Balance," (September 2002 issue brief; an update of a 1998 issue brief)

"Quantitative Measures for Evaluating Social Security Reform Proposals" (April 2002 issue brief)

2001

"Annuitization of Social Security Individual Accounts" (November 2001 issue brief)