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## POLICY BRIEF

### ***Social Security:*** Experts Discuss Funding Issues and Options

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**EXECUTIVE SUMMARY**

Due to the aging of Baby Boomers, longer life expectancies and other demographic factors, the Social Security system is faced with serious funding challenges, particularly since the ratio of workers to retirees will decline significantly over the next 2-3 decades. Currently, the system operates at a surplus and is adding to the coffers of the Trust Funds. However, according to Social Security actuaries, annual revenues from payroll taxes in 2017 no longer will be sufficient to cover benefits and the Trust Funds will need to be tapped, allowing scheduled benefits to continue until 2041. After that, assuming no change in tax rates or benefits, the Trust Funds would be depleted and benefits would drop by about one-fourth. Three TIAA-CREF Institute Fellows, each an expert on Social Security, convened recently to discuss options for closing the projected funding gaps. While all three agreed on certain points, such as the funding problem being “challenging, but not insurmountable,” there was a lack of agreement about the value of the President’s proposal for voluntary personal (or private) accounts.

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### INTRODUCTION

As nearly everyone knows, the Social Security system faces some important financing challenges unless significant changes are implemented. Fortunately, there are a number of options available to ensure a sound future, as discussed during a March 2005 web conference involving three academic experts. The challenge, as all agreed, is for policymakers to decide which options to pursue and to start implementing them as quickly as possible.

In conjunction with the American Council on Education (ACE) and the National Association of College and University Business Officers (NACUBO), the TIAA-CREF Institute organized a recent forum with three prominent scholars and Institute Fellows who are experts on Social Security reform: Olivia S. Mitchell, professor and executive director of the Pension Research Council at the Wharton School of the University of Pennsylvania; Joseph Quinn, professor of economics and dean of the College of Arts and Sciences at Boston College; and Robert Clark, professor of business management at North Carolina State University.

The discussion was broadcast live on March 16, 2005, and the recording is available through NACUBO's online library at <http://www.nacubo.org/x5361.xml>. This *Policy Brief* summarizes the March 2005 web conference, focusing on the significance of Social Security, the nature and extent of the funding problem, and options for reform. The impact of certain reform options on higher education also is addressed.

### THE SIGNIFICANCE OF SOCIAL SECURITY

Established in 1935, Social Security is the largest U.S. government program, providing annual benefits of about \$500 billion to approximately 48 million recipients. Designed as a social insurance program, Social Security today provides income for eligible recipients who become disabled, widowed, orphaned, or retire after reaching age 62. More than 90% of older Americans receive Social Security benefits, and two-thirds of the elderly count on the program for more than half of their income. Today the average recipient receives about \$10,000 in annual benefits. In his remarks, Professor Quinn noted that dramatic increases in Social Security benefits were responsible for the significant decline in elderly poverty during the late 1960s and early 1970s.

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### How Social Security Works

As described by Professor Clark, employees pay taxes on current earnings, generating a record that ultimately is used to calculate their future benefits. Currently, payroll taxes for Social Security are set at 12.4% on annual earnings up to \$90,000, with half, or 6.2%, paid by the employee and the other half by the employer. The benefits are wage-indexed, which means that during one's working years the calculated benefits grow at the same rate as general wages are growing. Once distributions begin, the benefits grow at the rate of the consumer price index. The current \$90,000 earnings cap on which taxes are paid also is indexed.

Currently, the Social Security program runs at a surplus, which occurs because payroll taxes collect more money than is required to pay today's beneficiaries. If the program were a simple pay-as-you-go system, the tax rate would be set so that revenues would just cover the total cost of today's benefits. Currently, with an average replacement ratio of 36% and about 3.3 workers for each retiree, a tax rate of 11% would create parity between system revenues and costs. However, since the current tax rate is 12.4%, a surplus is created. In 2004, the surplus amounted to about \$156 billion, which is the difference between the \$658 billion collected in payroll taxes and the \$502 billion paid out in benefits to retired workers, disabled persons, and survivors of former workers.

The Social Security system is accumulating the surplus in the form of special issue government bonds. These bonds, held by the Old-Age and Survivors Insurance and Disability Insurance (OASDI) Trust Funds, currently amount to about \$1.7 trillion. So, what's the problem?

### THE FUNDING PROBLEM

Quite simply, the problem has arisen because of the aging of America. As the huge bulge of Baby Boomers gradually enters retirement, the ratio of workers to retirees will shrink dramatically. By 2030, the ratio will have dropped to nearly two workers per beneficiary, and it is expected to drop slightly below the 2:1 ratio during the 2050s. If this demographic scenario plays out and scheduled benefits are maintained, the payroll tax rate would need to be raised to approximately 19%. Or, if the tax rate were held constant at 12.4%, benefits would have to be reduced by about 25%. As described by Professor Clark, the choice is either a tax hike or benefit cut, or some combination of the two.

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As noted, the scenario unfolds gradually. In fact, according to the recent actuarial report of the OASDI Trustees, annual surpluses are expected to continue until about 2017. After that, payroll taxes will no longer be sufficient to cover expenses, and the Trust Funds will need to be tapped to cover annual shortfalls. With no changes in the current tax rate and the method of calculating benefits, the Trust Funds can cover the growing annual deficits until 2041. At that point, the Trust Funds will be exhausted and payroll taxes would cover only about 74% of promised benefits, declining further to about 68% in 2079. The Social Security actuaries have computed that promised benefits will exceed projected revenues by \$4 trillion over the next 75 years, and \$11 trillion, or approximately the size of the U.S. Gross Domestic Product, when all future deficits beyond 75 years are included.

With greater numbers entering retirement and people living longer, Social Security's annual claim on Gross Domestic Product is expected to rise from slightly more than 4% currently to more than 6% over the next 30 years. As explained by Professor Clark, this means that out of every \$100 of earned wages, two additional dollars will need to be reallocated from other uses, such as food, housing, clothing, and entertainment, to cover the increased costs.

## REFORM OPTIONS

### Professor Mitchell's Remarks

Professor Mitchell described the recommendations of the 2001 Commission to Strengthen Social Security (CSSS), a bi-partisan task force commissioned by the President on which she served. The commission was given the challenge to develop recommendations that would: 1) improve the system's fiscal sustainability; 2) maintain benefits for retirees and near-retirees; 3) avoid raising payroll taxes; and 4) offer voluntary, individually-controlled, personal retirement accounts.

The commission's "Model 2" set of recommendations maintained current benefits for persons aged 55 and older, kept tax rates at current levels, and introduced voluntary personal retirement accounts with four percentage points of payroll tax up to \$1,000 annually (the cap would be wage indexed). In addition, the set of recommendations would "strengthen the safety net" by boosting low-earner benefits to 120% of the poverty line and by increasing surviving spouse benefits to 75% of couples' benefits. To restore system solvency, the commission recommended that benefits be indexed to prices, rather than to wages as they are now. Historically, wages have increased at an annualized rate of about 1.5 percentage points

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higher than prices. By indexing to prices, Mitchell explained, the bulk of the funding gap would disappear and future retirees would have the same purchasing power as they have today. She said that restoring the defined-benefit portion of the Social Security system to solvency would strengthen the system, not privatize it, notwithstanding some critics' claims to the contrary.

As recommended by the commission, the personal accounts: 1) would be voluntary, 2) would be invested in diversified and low-cost assets; 3) could be bequeathed in the event of premature death; 4) would be split in divorce; 5) would not be available for pre-retirement withdrawals; and 6) would be partially annuitized at retirement. Professor Mitchell said she believes that the option to invest in personal accounts would be a positive development, noting that the commission calculated that individuals would come out ahead if they earned a 2% real return (after inflation) on their personal account investments.

President Bush's recent proposal incorporates many of the CSSS's recommendations regarding personal accounts, such as the voluntary nature, the cap on personal-account contributions at 4% of pay, and the limited investment options. Both the commission and the President acknowledge that it will take more than the personal accounts to restore solvency to the Social Security system, and that additional measures will be required.

### Professor Quinn's Remarks

Professor Quinn discussed several reform options, offering his view that while measures are needed to close the expected funding gap, the basic structure does not need to be changed. One reform option would consist of raising the payroll tax by two percentage points, half paid by the employer and half by the employee, up to a total of 14.4%. This would eliminate the expected cumulative Social Security deficit projected by the OASDI Trustees over the next 75 years. Other options could include: a) raising or eliminating the earnings cap on which taxes are based so that high earners and their employers would contribute more to the system; b) raising or eliminating the earnings cap for just the employer's share; c) increasing the income taxes paid by retirees on Social Security benefits; d) delaying the eligibility age for receiving benefits; e) investing a portion of the Trust Funds in the equity market; f) converting to a means-tested system of benefits; and g) switching to indexing benefits to prices instead of wages, as discussed by Professor Mitchell. Professor Quinn was not advocating any particular remedy, but pointing out that many combinations of options are available to deal with the structural deficit.

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Professor Quinn described privatization as a very different philosophy of preparation for retirement—one that emphasizes individual responsibility rather than social insurance. He does not support the introduction of private (or personal) accounts, with the funds carved out of the current Social Security contribution, for the following reasons:

- It would unnecessarily change the basic structure of a very successful Social Security system without solving the funding problem. According to Professor Quinn, privatization would make the problem even bigger. “If you take one-third of an already inadequate income stream away, the deficit increases substantially, which is the reason the proposal has to be accompanied by federal borrowing and by significant declines in traditional Social Security benefits.”
- Individuals have other opportunities for investing in stocks, bonds and related vehicles. For example, many Americans invest private savings in these assets. Many employees have defined contribution (DC) employer-sponsored pension accounts, and more will in the future as employers increasingly opt for DC plans such as 401(k)s and 403(b)s, rather than traditional defined benefit (DB) plans. DB plans, like Social Security, specify the benefits that will be paid at retirement, usually based on earnings and years of employment. DC plans, on the other hand, define only the initial contribution. The trend toward DC pension plans has added to employees’ investment risk. From a portfolio perspective, Professor Quinn questioned whether it’s desirable to replace a valuable DB asset with unique characteristics (that is, Social Security) with assets similar to others already in the portfolio, particularly as numerous employers also are making this same shift from DB to DC plans. “Social Security, with inflation-indexed, lifetime benefits for the recipient (and often the spouse), are the key to retirement security for the majority of older Americans,” said Professor Quinn. “We should be very wary of changing the basic structure of such a successful program.”

With regards to higher education, Professor Clark referred to a recent survey by the American Association of University Professors indicating that 93% of private institutions offer only a DC plan, whereas more than half of public institutions offer a choice of DB or DC plan. As for financial ramifications, Professor Quinn noted that certain reform proposals, such as raising the payroll tax rate or the earnings cap on which taxes are calculated, would incur significant costs to institutions, particularly since staffing costs constitute such a large portion of their budgets.

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### CONCLUDING REMARKS

The Social Security system of collecting payroll taxes from current workers to pay the benefits of retirees has functioned well as long as revenue collected from workers was sufficient to pay retiree benefits. . However, due to the aging of the Baby Boomers, increased longevity, and rising benefit levels, the system is facing a financing crunch. According to the annual report of the Social Security Trustees, payroll taxes are expected to fully cover benefits for 10-15 more years, after which the Social Security Trust Funds will need to cover the shortfall. By 2041, under current rules, the Trust Funds are expected to be depleted and payroll taxes would cover only about 74% of promised benefits.

Proposals to fix the problem generally involve some combination of raising taxes or cutting benefits. One option being considered by the Administration is to change the benefit formula so that the indexation of benefits is calculated during one's working years by a consumer price index rather than by a wage index. Historically, wages typically have grown 1% to 1.5% faster per year than prices. By lowering the rate of increase in calculated benefits to the price inflation rate, the bulk of the gap would disappear, according to Professor Mitchell.

Speakers emphasized the need to start implementing changes soon, since the funding problem only worsens with time. In addition, they noted that Medicare will soon emerge as a far greater funding issue than Social Security, and so it's important to address Social Security before it becomes overshadowed. Their parting words for educators: teach your students about the need to plan and to save for retirement.

### About the Presenters

Robert Clark is professor of business management at North Carolina State University. He earned a Ph.D. from Duke University in 1974. His research specialties are pension and retirement policies, economics of aging, and labor economics. Professor Clark is a consultant to the TIAA-CREF Institute.

Olivia S. Mitchell is professor and executive director of the Pension Research Council at the Wharton School of the University of Pennsylvania. She earned a Ph.D. from the University of

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Wisconsin in 1978. Her areas of research include the economics of public and private pensions, health and retirement analysis and policy, risk and crisis management, employee benefits and compensation, among others.

Joseph F. Quinn is professor of economics and dean of the College of Arts and Sciences at Boston College. He earned a Ph.D. in Economics from the Massachusetts Institute of Technology. His areas of research include the economic status of the elderly, Social Security reform, and patterns of labor force withdrawal among older Americans, among others.

### **Additional Information:**

[http://www.tiaa-crefinstitute.org/Publications/policy/Brief\\_TSaving090104.pdf](http://www.tiaa-crefinstitute.org/Publications/policy/Brief_TSaving090104.pdf)

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