

Modernizing Social Security: An overview

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MODERNIZING SOCIAL SECURITY: AN OVERVIEW

BY ALICIA H. MUNNELL AND ANDREW D. ESCHTRUTH*

Introduction

While talk of Social Security reform typically focuses on the program's long-term financing gap, many policy experts also support targeted benefit changes to help economically vulnerable groups. Such changes are aimed at modernizing the system to account for evolving social, economic, and demographic circumstances such as the rising labor force participation of women, the decline in marriage rates, longer life spans, and sluggish wage growth. These trends have undermined the support that Social Security offers for caregivers, widows, the "oldest old," and very low earners.

The most discussed changes would: 1) provide credits for those who care for children; 2) improve support for widows; 3) ensure adequate income for retirees at advanced ages; and 4) offer a meaningful benefit to very low earners. Several of these improvements have been proposed by bipartisan commissions, suggesting widespread support.

This *brief* provides an overview of the four areas ripe for change; each one will be covered in-depth in separate *briefs*. The discussion proceeds as follows. The first section explains the basics of Social Security benefits. The second section describes the program's current long-term financial status. The third section introduces proposals for targeted benefit

changes. The fourth section addresses the cost of these changes and the need to adjust other benefits to offset the costs. The final section concludes that targeted changes could clearly help vulnerable groups but – given fiscal pressures – it is important to fully understand the nature of the problems, consider alternative ways to address them, and identify offsets to ensure that any changes are cost neutral.

How Social Security Works

Before exploring ways to change benefits for targeted groups, it is helpful to understand how Social Security works – specifically, how benefits are linked to earnings and marital histories.

Benefits Linked to Earnings

Social Security pays benefits to retired workers with 40 or more quarters of earnings in covered employment over their lives. Quarterly earnings must be above a minimal amount to qualify.¹ Benefits at the Full Retirement Age (FRA), which is currently moving from 66 to 67, are calculated using a three-step process.²

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First, a worker's previous earnings are restated in terms of today's wages by indexing past earnings to wage growth up to age 60. Second, indexed earnings for the highest 35 years are then averaged and divided by 12 to calculate Average Indexed Monthly Earnings (AIME). The final step is to calculate the Primary Insurance Amount (PIA), which is the sum of applying three separate percentages to portions of the AIME. The portions are determined by earnings thresholds – or “bend points” – that are indexed to wage growth. Specifically, the PIA for workers newly eligible for benefits in 2018 is the sum of:

- 90 percent of the worker's first \$895 of AIME +
- 32 percent of AIME between \$895 and \$5,397 +
- 15 percent of any AIME in excess of \$5,397.

This PIA is recalculated as long as the individual remains employed; it is indexed to prices from age 62. The monthly benefit actually paid depends on the age at which the worker claims. Benefits paid between age 62 and the FRA are actuarially reduced, and benefits paid between the FRA and 70 are actuarially increased.

Social Security also offers a special minimum benefit for people with a lifetime of low earnings. However, the initial amount of the minimum benefit is indexed to inflation, rather than wage growth. As a result, over time, the value of this benefit has eroded substantially compared to the standard benefit, so that very few workers currently receive it.

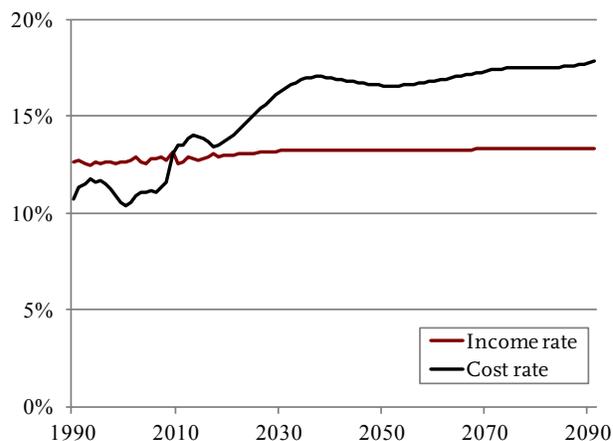
Benefits Linked to Marital History

Social Security provides dependent benefits to qualified spouses of retired workers. While these benefits are not gender based, they typically go to women because they tend to work less in the paid labor force and earn less than men. A wife is entitled to two types of benefits: 1) a spouse's benefit that will top up her own retirement benefit to 50 percent of her husband's PIA (unreduced for his early retirement); and 2) a widow's benefit that will top up her own benefit to 100 percent of her husband's benefit (reduced for early retirement). Divorced spouses are entitled to benefits if their marriage lasted at least 10 years.

Social Security's Current Financial Status

The Social Security actuaries project the system's financial outlook over the next 75 years under three sets of cost assumptions – high, low, and intermediate. The focus here is the intermediate assumptions, which show the cost of the program rising rapidly from about 14 percent of taxable payrolls today to about 17 percent in 2035, where it remains for several decades before drifting up toward 18 percent (see Figure 1). The increase in costs is driven by demographics, specifically the drop in the total fertility rate after the baby-boom period, resulting in fewer workers supporting each retiree. While costs are rising, income as a share of taxable payrolls is constant, so the gap between the income and cost rates means that the system is facing a 75-year cash flow deficit.

FIGURE 1. PROJECTED SOCIAL SECURITY INCOME AND COST AS PERCENTAGE OF TAXABLE PAYROLL, 1990-2095



Source: U.S. Social Security Administration (2017a).

This deficit is mitigated somewhat by the existence of a trust fund, with assets currently equal to about three years of benefits. These assets are the result of cash flow surpluses, which began in response to reforms enacted in 1983. Before the Great Recession, these surpluses were expected to continue for several years, but the recession-induced decline

in payroll taxes and uptick in benefit claims caused costs to exceed payroll taxes in 2010. This shift from surplus to deficit means that Social Security is now tapping the interest on trust fund assets to cover benefits. And, in 2021, taxes and interest will fall short of annual benefit payments, requiring the program to begin drawing down trust fund assets to meet benefit commitments. The trust fund is projected to be exhausted in 2034.

The exhaustion of the trust fund does not mean that Social Security is “bankrupt.” Payroll tax revenues will keep rolling in and can cover about 75 percent of currently legislated benefits over the remainder of the projection period. Relying only on current tax revenues, however, would require a 25-percent across-the-board cut in benefits.

Moving from cash flows to the 75-year deficit requires calculating the difference between the present discounted value of scheduled future benefits and the present discounted value of future taxes plus the assets in the trust fund. This calculation shows that

Social Security’s long-run deficit is projected to equal 2.83 percent of covered payroll earnings. That figure means that if payroll taxes were raised

immediately by 2.83 percentage points – 1.42 percentage points each for the employee and the employer – the government would be able to pay the current package of benefits for everyone through at least 2090. Numerous proposals exist on both the revenue and benefit sides for closing the financing gap.

At this point in time, solving the 75-year funding gap is not the end of the story in terms of required revenue increases or benefit reductions. Because the ratio of retirees to workers is rising and the cost rate is increasing, any package that restores balance only for the next 75 years will show a deficit in the following year as the projection period picks up a year with a large negative balance. Policymakers generally recognize the effect of adding deficit years to the valuation period and advocate a solution that involves “sustainable solvency,” in which the ratio of trust fund assets to outlays is either stable or rising in the 75th year. Realistically, then, eliminating the 75-year shortfall should probably be viewed as the first step toward long-run solvency.

Four Proposals for Targeted Benefit Changes

In tandem with restoring solvency to Social Security, many policy experts also stress the need to make targeted benefit changes to help vulnerable groups.³ This *brief* introduces four such changes: caregiver credits, widows’ benefits, income security at older ages, and minimum benefits for low earners.

Provide Caregiver Credits

Individuals who care for small children (or the elderly) often reduce their work hours or temporarily drop out of the labor force. Such gaps in work history can significantly reduce lifetime earnings and, in turn, Social Security benefits. In response, other countries often provide caregiver credits to ensure that the value of caregiving activity is partially reflected in retirement benefits.

Targeted benefit changes can help vulnerable groups and be fiscally responsible.

One U.S. proposal would credit parents who have a child under age six with earnings for up to five years. The earnings would be limited to one half of the Social Security Administration’s average wage index (\$24,321 in 2016).⁴ Another approach would provide up to five childcare “drop-out” years when calculating an individual’s Social Security benefits. Thus, a caregiver’s career average earnings would be based on the highest 30 years, rather than the highest 35 years.⁵

Improve Widow Benefits

As noted above, a widow is eligible for a benefit equal to her deceased spouse’s actual benefit (if it exceeds her own worker benefit). Under the traditional model of a one-earner couple, the widow’s benefit would equal 67 percent of the total benefits that the household received when both members of the couple were still alive. For a two-earner couple with equal earnings, the widow would receive 50 percent of the total benefits.

One popular proposal would increase the widow benefit to 75 percent of the amount the household received when both members of the couple were still alive. To target the higher benefit to those most in need, this proposal would typically limit the dollar amount of the increased widow benefit to the amount received by a worker-beneficiary with average earnings.⁶

Ensure Adequate Income at Older Ages

Policy experts have long been concerned that retirees are more financially vulnerable as they reach advanced ages. This risk is greater in a world in which private pension income has shifted from the automatic lifelong payouts of a defined benefit plan to the uncertain income stream of a 401(k). The risk is further increased by rising life expectancy, which swells the ranks of the “oldest old” (typically those ages 85 and above).

Two proposals aim at protecting the oldest old. One focuses on the appropriate inflation index for adjusting benefits each year. Some are concerned that the current index underweights health spending by the elderly; they propose switching to a Consumer Price Index for the Elderly (CPI-E). The other proposal would provide an automatic 5-percent increase in monthly benefits at age 85. Similar to the widow benefit change, the dollar amount of this increase would be limited to the average retired-worker benefit.⁷

Protect the Lowest Lifetime Earners

As noted above, workers with very low average wages are eligible for a special minimum benefit that was originally intended to protect full-career workers from poverty in retirement. However, this benefit is insufficient and is rapidly becoming irrelevant; soon, no new retirees will receive it at all.⁸

One popular proposal would increase the minimum benefit to 125 percent of the poverty level. It would also adjust the initial benefit going forward by indexing it to wages rather than prices to avoid the design flaw in the current minimum benefit.⁹

Costs and Offsets

The combined cost of the four benefit changes – without any budgetary offsets – would be either 0.41 percent or 0.86 percent of taxable payroll over 75 years,

depending on the options selected for caregivers and the oldest old (see Table 1). As noted above, when considering changes to Social Security, it is important to look beyond the 75-year period in order to ensure sustainable solvency, so Table 1 also shows the costs of the targeted benefit changes in the 75th year.

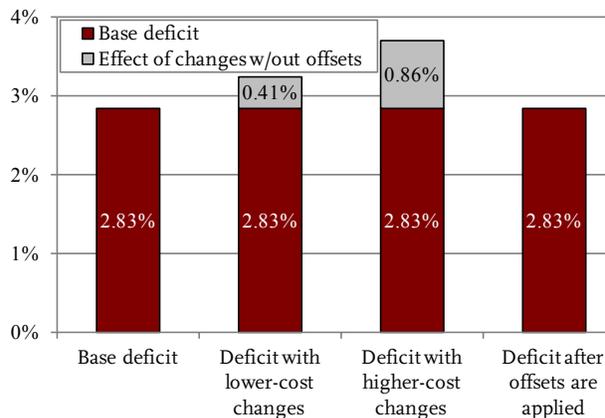
TABLE 1. COSTS OF TARGETED BENEFIT CHANGES OVER 75 YEARS AND IN THE 75TH YEAR

| Benefit change | Impact of change on: | |
|-------------------|----------------------|----------------------------------|
| | 75-year balance | Balance in 75 th year |
| Caregiver credits | -0.05/-0.22% | -0.05/-0.32% |
| Widow benefits | -0.12 | -0.13 |
| Oldest old | -0.11/-0.39 | -0.16/-0.54 |
| Minimum benefit | -0.13 | -0.19 |
| Total | -0.41/-0.86% | -0.53/-1.18% |

Sources: U.S. Social Security Administration (2017b, c).

To put the total cost into perspective, the targeted changes would add either 14 percent (the lower-cost package) or 30 percent (the higher-cost package) to Social Security’s deficit over the 75-year horizon. To ensure that such improvements are fiscally responsible, these costs could be fully offset by reductions in other benefits. A key objective of this series of *briefs* is that any benefit changes be cost-neutral, so that they would not add to Social Security’s overall cost rate or deficit (see Figure 2).

FIGURE 2. EFFECT OF TARGETED BENEFIT CHANGES ON SOCIAL SECURITY’S 75-YEAR DEFICIT



Source: U.S. Social Security Administration (2017a, b, c).

In choosing how to offset the costs of targeted improvements, policy experts tend to focus on redirecting resources from less vulnerable to more vulnerable groups, without fundamentally changing the character of Social Security as a broad social insurance program for all workers. Examples include lowering the PIA factor currently applied to a portion of higher earners' wages from 15 percent to 5 percent and reducing the spousal benefit. These two changes by themselves could fully offset the lower-cost package of benefit improvements. Covering the higher-cost version would require additional offsets, such as further lowering benefits for spouses of higher earners or, perhaps, slightly modifying the cost-of-living-adjustment for all beneficiaries.¹⁰

To keep the costs (and required offsets) down, policymakers might choose to adopt some, but not all, of the targeted benefit changes. It is worth noting that some of the changes may complement or overlap others. For example, a caregiver credit boosts earnings records, which could make it easier to gain eligibility for an improved minimum benefit.¹¹ An example of overlap is the widow benefit and the age-85 increase, which both raise benefits for older widows.

Conclusion

In recent years, support for targeted Social Security benefit changes – as part of a broad package to restore long-term solvency – has gained currency among legislators, advocates, and other policy experts. Such changes could help modernize the program's benefit structure and substantially help vulnerable groups.

Adopting the four most frequently mentioned changes without budgetary offsets would raise Social Security's 75-year deficit by up to 30 percent. Therefore, a key objective in analyzing these proposed changes is ensuring that they are cost neutral. To this end, the companion *briefs* in this series will take a closer look at each of the targeted changes to fully understand the problem, consider alternative solutions, and spell out specific offsets. The goal is to suggest options for modernizing Social Security that can be both effective and fiscally responsible.

Endnotes

1 The earnings threshold for one quarter of coverage in 2018 is \$1,320.

2 For individuals reaching age 62 in 2018, the FRA is 66 and 4 months.

3 For a thorough discussion, see Diamond and Orszag (2004).

4 See, for example, Entmacher, Waid, and Veghte (2016) and Reno and Lavery (2009). The amount for average wages relies on the most recently available data from the Social Security Administration.

5 This proposal was in a 2016 bill proposed by former Rep. Patrick Murphy (D-FL).

6 This proposal is included in a 2017 bill by Rep. Al Lawson (D-FL). Under an alternative and somewhat more generous version, a widow would receive 100 percent of her own benefit and 75 percent of her deceased spouse's benefit (Commission on Retirement Security and Personal Savings, 2016).

7 Similar proposals by the Debt Reduction Task Force (2010) and The National Commission on Fiscal Responsibility and Reform (2010) would raise benefits by 1 percent per year for older retirees for five years.

8 Feinstein (2013).

9 Such a proposal is included in a 2017 bill by Sen. Bernie Sanders (I-VT) and Rep. Peter DeFazio (D-OR) and supported by The National Commission on Fiscal Responsibility and Reform (2010).

10 Both the costs and offsets discussed here and throughout this series of *briefs* use estimates from the Social Security actuaries that exclude any interaction effects among the various provisions.

11 For this reason, as discussed in Eschtruth and Munnell (2018 forthcoming), a form of caregiver credit is sometimes included in proposals for enhancing the minimum benefit. See, for example, Entmacher, Waid, and Veghte (2016).

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