

Commentary

BUFFIN PARTNERS INC.

ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

A View from the Treasury: Part Five

The U.S. Treasury has issued the fifth in its series of Issue Briefs on Social Security. This Issue Brief discusses progressive price indexing and the potential role of progressive reductions in scheduled benefits as part of Social Security reform. A progressive reduction in scheduled benefits would have high earners bear a relatively larger share of the impact of the reductions while lower earners would be affected to a much lesser extent. The Treasury notes that Social Security is projected to have sufficient funds to pay scheduled benefits until 2041 but payment of scheduled benefits beyond 2041 requires additional revenues. A number of recent proposals for progressive price indexing are similar in terms of progressively reducing the growth rate of benefits; advocates of progressive price indexing claim that proposals to reduce scheduled benefits typically do not actually cut benefits in either nominal or real terms but that benefits of successive birth cohorts continue to grow over time, albeit at a slower rate than benefits scheduled under current law. According to the Treasury view, reforms that maintain the system in actuarial balance by slowing future benefit growth have the potential to be fairer to future generations than reforms that achieve solvency by raising payroll taxes.

Increasing payroll taxes has the effect of tilting the system to a greater degree of pre-funding as more resources are brought into the system in advance of when benefits are payable. However, as Treasury points out, pre-funding provides resources for future generations only if the increased Social Security revenues do not result in higher spending or lower taxes in the non-Social Security part of the unified budget. Since this is already a problem with large and

increasing deficits in the unified budget, Treasury is concerned that increasing payroll taxes would effectively make the problem worse and create an even greater burden for future generations. The heart of the problem is not with Social Security benefit provisions but with the deficits in non-Social Security spending. What is essentially a political issue for a democratic society is whether scheduled Social Security benefits should be reduced for future beneficiaries directly or indirectly as a result of the deficits in non-Social Security government spending that are not completely transparent in the unified budget.

Under present Social Security law, retirement benefits are computed by a formula that involves three steps. First, an average of a worker's taxable earnings is calculated, including indexing of earnings prior to age 60 to economy-wide average wages (EWAW), to produce average indexed monthly earnings (AIME) based on the highest 35 years of indexed covered earnings. Second, a Primary Insurance Amount (PIA) is computed based on AIME and a three-part formula for the year a new beneficiary is age 60. For the part of AIME up to 22 percent of EWAW the PIA is 90 percent; for AIME between 22 and 131 percent of EWAW the PIA is an additional 32 percent; and for AIME above 131 percent of EWAW the PIA is an additional 15 percent. The formula is progressive with respect to the effect of the 90, 32 and 15 percent factors applied to the three tiers of AIME. Third, the PIA is adjusted for retirement before or after the normal retirement age including price inflation between age 62 and the commencement of benefit payments. Adjustments occur thereafter for price inflation each year during the course of the payment period.

A direct approach to progressive benefit adjustments might involve a reduction in one or more of the benefit percentages, such as changing the top rate from 15 to 10 percent or changing the middle rate from 32 to 16 percent and the top rate from 15 to 7.5 percent. Another significant concept in some proposals is to reduce the growth of benefits by modifying the benefit computation so that new benefit awards for successive birth cohorts grow with prices rather than with wages. This price indexing approach would reduce future benefits since the growth rate of real wages is generally positive as productivity gains produce higher real wages. The Treasury Issue Brief emphasizes that under this approach, all aspects of current law that rely on wage indexing would be unchanged under price indexing; what would change is that benefits as defined by current law would be multiplied by the ratio of economy-wide average real wages in a base year to economy-wide average real wages in the year a worker reaches age 60, so that benefits would be scaled down by the amount by which nominal wages have outpaced prices. Current projections indicate that the effect would be to reduce scheduled benefits by 1.1 percent for the first birth cohort affected, by 2.2 percent for the second birth cohort affected, and so on with an increasing effect over the long-term.

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