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Social Security Reform and the Cost of Delay August 22, 2013

The longer policymakers wait to begin to reform our entitlement programs and reduce our debt, the harder it will be. Nowhere is this more obvious than in the Social Security system, which is currently on a road toward insolvency. Since 2010, the program has been paying more in benefits than it generates in revenue – a trend that will continue indefinitely. By 2033, the combined trust funds will run dry, at which point all beneficiaries regardless of age or income will face an immediate 23 percent reduction in their benefits.

Of course, neither political party believes we should allow the currently projected 23 percent across-the-board cut to take place. However, many have suggested a lack of urgency in addressing Social Security's challenges – arguing that plenty of time remains to responsibly address the program's shortfall.

That time, unfortunately, is running out. The year 2033 is not that far away in the context of a long-term retirement system with such serious funding challenges. In 2033, a new 62 year-old retiree today will be 82 years old and relying on the program; and today's 47 year-old will be reaching the normal retirement age of 67.

Assuming policymakers avoid the 23 percent across-the-board projected benefit cut, it is important to understand that the longer they wait to begin implementing reforms, the greater the cost. The costs of waiting to act include:

1. **Per person benefit cuts and tax increases will be larger** as fewer cohorts of taxpayers and beneficiaries are able to share the cost of restoring solvency. *As a result, achieving solvency would require a 23 percent across-the-board benefit cut in 2033, compared to 16.5 percent if enacted today.*
2. **Less time will be available for interest to accumulate** within the trust fund to lengthen its life. *As a result, achieving solvency would require 4.2 point payroll tax hike in 20 years, compared to 2.7 points if enacted today.*
3. **Real cuts in benefits**, as opposed to the slowing of benefit growth, will become increasingly inevitable. *As a result, price indexing benefits alone is likely no longer sufficient to ensure the program remains solvent.*
4. Workers will have **less time to plan or adjust** for programmatic changes. *As a result, a 30 year old would have to set aside 2 to 2.7 percent of income to replace a 10 percent benefit cut in 20 years, compared to 0.7 to 1.1 percent today.*

For these reasons and more, waiting to enact reforms would be a significant mistake, and the same is true for other areas of the budget. The longer policymakers wait to act, the worse off taxpayers and beneficiaries will be.



Waiting to Act Places a Greater Burden on Fewer People

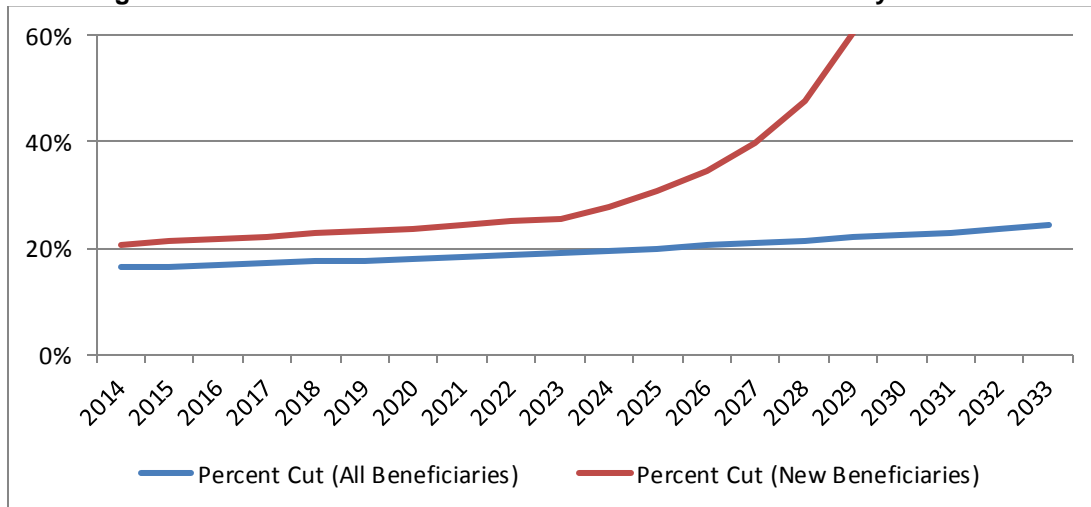
Social Security is generally financed as a closed system. This means that (with some exceptions) benefits paid out over the life of the program cannot exceed the taxes paid in over the life of the program (plus interest). Of course, the more people who are in the system over its lifetime, the more people who can contribute to its solvency through higher-than-scheduled revenue contributions or lower-than-scheduled benefit collection. The longer we wait to enact reform, the more participants who will no longer be alive and therefore no longer able to help contribute to the solution. With fewer Americans contributing, each will face a greater burden.

The real-world constraints of an aging population are far more significant than the technical constraints, however. As taxpayers become beneficiaries, most policymakers would exempt them from major changes – both for political reasons and genuine fairness and hardship concerns associated with changes for those who already count on their monthly Social Security checks. Some would even go further and exempt those within several years of retirement.

Every year we wait means more workers crossing into retirement in which they will be largely exempted from change – especially during the rapid retirement of the Baby Boom population. In the coming years, the number of Social Security beneficiaries will rise from 47 million only a decade ago to 58 million this year, 75 million in ten years, and almost 90 million in 20 years.

As an increasing number of workers pass the threshold into becoming retirees or near-retirees, the pool of workers available to pay more in Social Security taxes or receive less-than-scheduled benefits will shrink. As a result, the remaining workers will need to bear a larger benefit cut in retirement and/or a larger tax increase during their working lives.

Fig 1. Percent Benefit Cut Needed to Close 75-Year Shortfall by Start Date



To understand the additional per-person burden of waiting, one can measure the percent benefit cut needed to achieve 75-year solvency. If policymakers were to act (abruptly) today, a **16.5 percent** across-the-board cut for all beneficiaries would achieve solvency for the next 75 years. Waiting ten years would require a **19 percent cut**, and waiting 20 years would require a



23 percent cut. If we only apply the cuts to new beneficiaries, the required cut would be nearly **20 percent** this year, **30 percent** in a decade, and **83 percent** by 2030. After that, it would be impossible to avoid insolvency solely with benefit cuts to new beneficiaries.

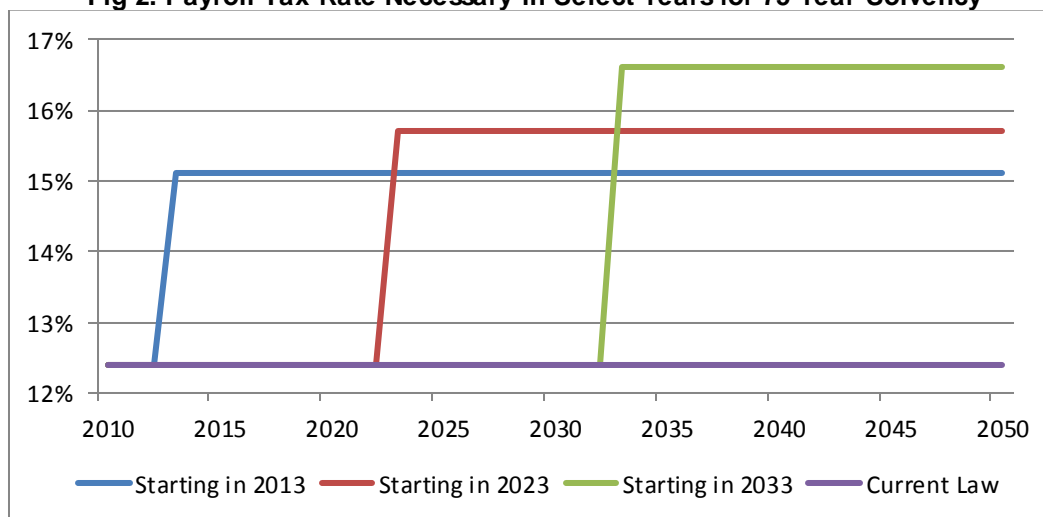
Waiting to Act Reduces the Accumulation of Interest in the Trust Fund

In addition to focusing the cost of reform on fewer age cohorts, waiting to act reduces the opportunity for the Social Security trust fund to accumulate interest. Currently, the Social Security trust funds hold \$2.8 trillion of government bonds, which earn interest that can be legally used, along with the principal, to pay benefits. The larger the programmatic deficit in a given year, the less principal is available in the next year to generate interest for the trust fund.

Although there is legitimate concern as to whether the funds in the Social Security trust fund can be “saved” in an economic sense¹, from a legal perspective, changes made sooner can actually be smaller while achieving the same 75-year (though not 75th year) financial result. Trust fund accounting aside, smaller short- and medium-term deficits in Social Security will mean fewer net interest payments by the government and, therefore, slower growing debt.

One way to understand the value of interest savings is to understand that every dollar of benefits paid for from interest is a dollar which need not (legally) be paid for from taxes. This is best illustrated by estimating the necessary payroll tax rate to achieve solvency depending on enactment date. Acting immediately, an increase in the payroll tax from 12.4 to 15.1 would achieve 75-year solvency. Waiting until 2023, the necessary rate would be 15.7 percent. If we waited until 2033, the necessary rate would be 16.6 percent.²

Fig 2. Payroll Tax Rate Necessary in Select Years for 75-Year Solvency



¹ Some experts have argued that by reducing past deficits, Social Security surpluses have in some sense been “saved” so far as they have reduced public debt and resulting interest costs (see Diamond, Social Security, the Government Budget and National Savings). However, a large body of evidence suggests that in reducing the unified deficit, Social Security’s surpluses have led to higher general spending and lower general taxes than would have otherwise occurred and as a result some or all (or more than all) of the surpluses have been “spent” (see Smetters, Is the Social Security Trust Fund Worth Anything?).

² Importantly, achieving sustainable solvency would eventually require the rate be raised further. But it could be done later and on a wealthier set of workers.



Waiting to Act Makes Cuts in Real (Inflation-Adjusted) Benefits Harder to Avoid

By design, Social Security benefits increase in real terms from cohort to cohort, as initial benefits are indexed to average wage growth. This growth in per-person benefits is a key driver of the program's cost growth, and slowing such growth offers an opportunity to restore solvency without making future beneficiaries any worse off than current beneficiaries, even adjusted for inflation.

Yet, because the base level from which future changes in benefits grows each year, the longer we wait the harder it will be to achieve solvency by simply slowing the growth of benefits. This point can be demonstrated by evaluating the effect of a policy known as "price indexing," where initial benefits are modified to grow with prices in each new cohort, as opposed to wages.

The Social Security actuaries find that implementing price indexing starting in 2019 would close about 95 percent of the 75-year actuarial gap. By comparison, starting only one year earlier in 2018 would be sufficient to close the entire 75-year shortfall and starting earlier than that would allow for ample room to ease up on the policy or accompany it with benefit expansions.

Importantly, while indexing new benefits to prices could still be sufficient to close the 75-year gap on the whole, it is now unlikely to be sufficient to avoid at least a temporary period of insolvency. Price indexing benefits beginning in 2019 would extend the life of the trust fund by only one year – from 2033 to 2034. Starting earlier could extend the life a few more years, but by our estimates any future start of price indexing will likely be insufficient to avoid trust fund exhaustion. By comparison, had such a policy been implemented at the beginning of this decade it would have been sufficient to avoid trust fund exhaustion *and* maintain 75-year solvency.

Of course, additional options exist to improve the state of the trust fund while avoiding real cuts in benefits. On the spending side, adopting the chained CPI would close 20 percent of the gap. On the revenue side, any number of options to change the tax rate or base could accompany spending reforms. However, most reform plans aim to maintain some degree of real benefit growth for all but the very richest beneficiaries. That means these other changes will have to make up that the difference, and the longer policymakers wait, the larger the gap.

Currently, it is possible to design a reform plan in which benefits continue to grow (or at least are not cut) in real terms and lower-income populations are largely exempted from overall from changes in the benefit formula. Soon, policymakers will be forced to violate one of these two parameters. Eventually, they may have to violate both – proposing real cuts in benefits and subjecting a broad swath of beneficiaries to those cuts.

Waiting to Act Leaves Workers with Less Time to Plan and Adjust

Currently, 162 million workers pay Social Security payroll taxes and are counting on Social Security as part of their overall retirement strategy. In theory, Social Security is meant as part of

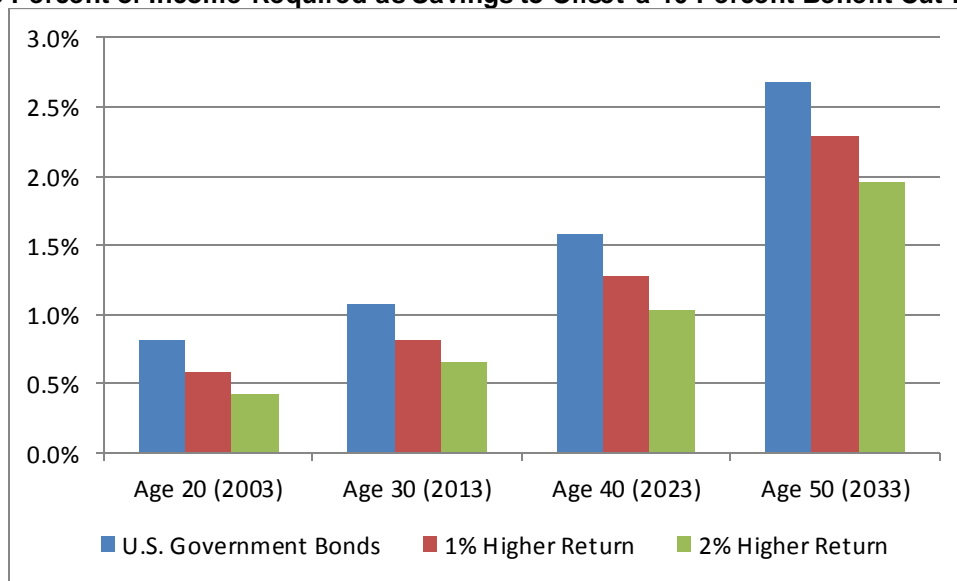


a “three-legged stool” that also includes employer pensions and personal savings – and in some cases, some amount of work in retirement.

Many workers plan for their retirement in advance, setting work and savings targets to ensure they can finance their lives in old age. Large and abrupt changes in Social Security benefits – which will become increasingly necessary as time passes without legislative action – can disrupt those plans. By comparison, workers who become aware of changes in their expected Social Security payments well in advance can plan and adjust to these changes.

As an example, imagine a 30-year old making \$50,000 per year is told her benefits will be 10 percent lower than expected when she retires in 2050. Assuming an average life expectancy, these losses could be made up for by setting aside an additional **1.1 percent** of the worker’s salary in low-risk, low-yielding government bonds. By comparison, if the same person was told about the same exact 10 percent benefit cut in 2033 at age 50, she would have to set aside **2.7 percent** of her salary to make up for the loss – a much more difficult task. If the worker instead saved this money in a higher-yielding stock index fund that performed 2 percent better annually than bonds alone, savings of **0.7 percent** might be sufficient if alerted today while **2.0 percent** would be necessary if alerted at age 50 – an almost three-fold difference in necessary savings. Investing in stocks is also much riskier at older ages due to stock volatility.

Fig. 3 Percent of Income Required as Savings to Offset a 10 Percent Benefit Cut in 2050



Until a worker knows the level of benefits to expect, it is difficult to plan around it – not only by setting savings targets but by deciding how to allocate that savings, by targeting an age and strategy for retiring, and by making other financial decisions throughout life. The benefits of certainty are significant. Indeed, a 2006 study by Francisco Gomes, Laurence Kotlikoff, and Luis Viceira finds that the economic cost of current government indecision on Social Security – separate from the impact of the policy choice as outlined above – is as high as 0.6 percent a



person's economic resources.³ This cost is not insignificant, especially when added to the other very real costs of waiting and the lack of any identifiable benefit in doing so.

Conclusion

The fact that Social Security faces a funding problem is not in dispute, and the choices available to fix it are well known. Indeed, a tool that CRFB has previously released, [The Reformer](#), allows users to easily design their own plans at <http://www.socialsecurityreformer.org>. Unfortunately, some policymakers and commentators have used the 2033 insolvency date of the Social Security combined trust funds as an excuse for inaction. That would be a mistake.

Failing to act to reform Social Security by 2033 would result in an immediate 23 percent across-the-board benefit cut affecting all beneficiaries regardless of age, income, or status. Well before 2033, however, the choices available to reform Social Security will begin to narrow, and the necessary changes short of ending the self-contained nature of the program will become far more abrupt and severe.⁴

The longer we wait to restore the Social Security program to solvency, the greater the burden will be borne by fewer workers and beneficiaries, the less we will be able to rely on interest payments to extend the life of the program, the more unavoidable real reductions in benefits will become, and the less time today's workers will have to plan and adjust.

On the other hand, a reform plan enacted today could make small and gradual changes that accumulate over time in a way that makes the program sustainably solvent, allocates taxes and benefits fairly, and gives workers plenty of time to prepare for changes.

It is for this reason that the Social Security Trustees make but one recommendation in their annual report:

The Trustees recommend that lawmakers address the projected trust fund shortfalls in a timely way in order to phase in necessary changes and give workers and beneficiaries time to adjust to them. Implementing changes soon would allow more generations to share in the needed revenue increases or reductions in scheduled benefits.

The right time to act to reform Social Security was two decades ago. The next best time is now.

³ Francisco Gomez, Laurence J. Kotlikoff, and Luis M. Viceira. "The Excess Burden of Government Indecision," August 2006. <http://www.mrrc.isr.umich.edu/publications/conference/pdf/UM06-16A0806C.pdf>

⁴ Of course, one option is to simply break the link between Social Security's dedicated revenue and its benefits. Funding Social Security from general revenues could avoid the threat of "insolvency," but at the cost of dramatically increasing debt levels or directly squeezing out priorities in the rest of government and at the risk of making Social Security vulnerable to short-term changes in regular budget battles. Blahous's "The End of Social Security Self-Financing" includes a thorough discussion of this possibility:

http://mercatus.org/sites/default/files/TheEndofSocialSecuritySelfFinancing_Blahous_v1-1_0.pdf.