NONPARTISAN SOCIAL SECURITY REFORM PLAN

Jeffrey Liebman, Maya MacGuineas, and Andrew Samwick[1]

December 14, 2005

OVERVIEW

The three of us – former aides to President Clinton, Senator McCain, and President Bush – did an experiment to see if we could develop a reform plan that we could all support. The Liebman-MacGuineas-Samwick (LMS) plan demonstrates the types of compromises that can help policy makers from across the political spectrum agree on a Social Security reform plan. The plan achieves sustainable solvency through progressive changes to taxes and benefits, introduces mandatory personal accounts, and specifies important details that are often left unaddressed in other reform plans. The plan also illustrates that a compromise plan can contain sensible but politically unpopular options (such as raising retirement ages or mandating that account balances be converted to annuities upon retirement) -- options that could realistically emerge from a bipartisan negotiating process, but which are rarely contained in reform proposals put out by Democrats or Republicans alone because of the political risk they present.

The LMS plan contains four key elements:

Benefit cuts (through progressive reductions in PIA factors and an increase in the retirement age).

New revenue (through a mandatory additional 1.5 percent contribution into personal retirement accounts and a gradual increase in the payroll tax cap to 90 percent of earnings).

Mandatory personal retirement accounts (equal to 3 percent of earnings, funded half by new contributions and half redirected from the Social Security Trust Funds, with full annuitization required upon retirement).

Other updates to the traditional system (minimum benefit for low-wage workers, increase in widow(er)s' benefits, decrease in spousal benefits, possible progressive matches for accounts).

---

[1] Jeffrey Liebman is Professor of Public Policy at Harvard University. From 1998 to 1999, he was Special Assistant to President Clinton for economic policy and coordinated the Clinton Administration's Social Security reform technical working group. Maya MacGuineas is Director of the Fiscal Policy Program at the New America Foundation. She was a Social Security adviser to Senator McCain during the 2000 presidential campaign. Andrew Samwick is Professor of Economics and Director of the Nelson A. Rockefeller Center for Public Policy at Dartmouth College. From 2003 to 2004, he was Chief Economist on the staff of President Bush's Council of Economic Advisers, where his responsibilities included Social Security.

<u>The major compromises in the plan include:</u>

Revenue increases versus spending reductions - To fill the Social Security funding gap, roughly half the changes would come from benefit reductions and half from revenue increases. (Over the 75-year horizon, benefits cuts would equal 2.7 percent of payroll and revenue increases would equal 2.5 percent of payroll.)

Level of traditional benefits – In the long run, traditional benefits would be no smaller and no larger than the existing 12.4 percent payroll tax. Not allowing benefits to grow as promised would keep them from crowding out spending on other programs and minimize the need for distortionary tax increases and government borrowing. Not allowing them to fall below 12.4 percent would alleviate fears about starting down the slippery slope to total privatization. This level of benefit reductions is intermediate between price indexing and wage indexing. The benefit reductions are completely phased in by 2050 and benefits grow with real wages thereafter.

Level of benefits versus length of time of collecting benefits – Under the plan, the combination of traditional benefits and the money accumulated in accounts produces replacement rates (the ratio of retirement income to pre-retirement earnings) roughly equal to those that are currently promised. In addition, replacement rates from the traditional benefit alone are kept higher than they would otherwise be because benefits would be collected over a shorter period of time due to the increase in the age when participants become eligible for benefits.

Sources of PRA financing – Half of the revenue needed to fund the PRAs would come from mandatory worker contributions (an "add-on") and half would come from redirecting money from the Social Security Trust Funds (a "carve-out"). Rather than borrowing to cover the cost of the redirected funds, they would be paid for by raising the payroll tax cap and cutting benefits.

Storage for saving – While new money would be devoted to the Social Security system, on net, all of the new revenue would be stored in personal accounts rather than in government trust funds. Accounts wall off funds from the rest of government, thereby increasing the likelihood that they would contribute to national saving. Devoting the new revenues to accounts would also decrease their distortionary effects, as workers will be less likely to perceive their required contributions as a pure tax if they see those contributions being directed to an account that they own.

Size of the accounts – At three percent, personal accounts would be large enough to accumulate significant wealth for participants and to keep the administrative costs manageable but not so large as to overshadow traditional benefits.

Level of progressivity – Revenues and traditional benefits would be made more progressive but not so much as to undermine support for the universal social insurance system.

DETAILS

I. Benefit Cuts

The LMS plan reduces scheduled benefits so that they can be covered by the current 12.4 percent payroll tax.[2] This represents a 35 percent reduction in aggregate spending relative to current benefit formulas. Because benefits for the disabled and young survivors are not reduced, the retirement benefit cut for a typical worker is larger—about 43 percent.[3] The benefit cuts are implemented by changing the primary insurance amount (PIA) formula and by increasing the full benefit age.

Changing the PIA Formula

The reductions in benefits via the PIA formula are done in such a way that benefits are reduced by a greater percentage for high earners than for low earners. The upper (15) and middle (32) PIA factors are gradually cut in half—to 7.5 and 16 percent, respectively. The lower PIA factor (90) is reduced by only a quarter, to 67.6 percent. The reduction in the top PIA factor is phased in for beneficiaries first becoming eligible for benefits between 2008 and 2045. The reductions in the other two PIA factors are phased in between 2013 and 2050. The speed at which the reductions are implemented is designed to align with the speed at which PRA balances accumulate so that total replacement rates (from the sum of traditional benefits and PRA annuities) remain roughly constant across cohorts.

Increasing the Retirement Age

Under current law, the age at which a worker can receive full retirement benefits is scheduled to rise from its current level of 66 to 67 between 2017 and 2022. The LMS plan would advance this transition by eleven years, starting the increase in 2006, and then would continue the increase in the full benefit age (FBA) until it reached 68 for those attaining age 62 in 2017. Absent a change in retirement date, an increase in the FBA represents a benefit reduction for beneficiaries.

The plan also includes an increase in the earliest eligibility age (EEA). Starting for people born in 1955, there would be an increase the EEA (which is currently 62) by 2 months per year until it reaches 65. When people delay receiving Social Security benefits, their remaining benefits are increased by an amount that is roughly actuarially fair. Therefore, an increase in the EEA has essentially no impact on Social Security's finances. However, it is likely to have positive labor market effects.

---

[2] The payroll base for this calculation is the currently scheduled one, not the expanded one described below. Note also that these cuts to the traditional benefit are deeper than those required to bring the pay-as-you-go system into balance since revenue under the status quo includes both payroll tax revenue and revenue from the taxation of Social Security benefits.

[3] These benefit reductions refer to *traditional* benefits only; they do not reflect the level of *total* benefits, which would be larger due to the combination of traditional benefits and the personal accounts.

Raising the FBA and EEA reflects that with rising longevity and improved health at each age, an important part of reforming Social Security should be to pay benefits primarily at older ages, thereby encouraging people to work longer (in part by changing societal norms about when retirement should begin). We raise the EEA, even though it has no impact on Social Security's finances, because we want to maintain replacement rates in light of benefit cuts (particularly to protect individuals who might shortsightedly retire too early if given access to their Social Security benefits at too young an age).[4]

Protecting the Disabled and Child Beneficiaries from Benefit Cuts

Benefits for disabled workers and their dependents and for child beneficiaries would not be subject to the reductions in benefits from changing the PIA formula. These beneficiaries would continue to receive benefits under the current formula. For disabled beneficiaries who reach the full benefit age and are then converted to retired worker status, benefits would be paid as a weighted average of the benefits under the new formula and the old formula. Specifically, the benefits will equal the share of years the worker was not disabled times the new formula plus the share of years the worker was disabled times the old formula. Disabled workers will have access to their PRA annuities under the same terms as retired workers – i.e. they may choose to convert balances to an annuity and start receiving benefits at any age between 62 and 68.

II. New Revenue

There are two sources of new revenue in the plan: mandatory account contributions and an increase in the level of earnings subject to the payroll tax.

Mandatory Account Contributions

The personal retirement accounts (described in detail below) are financed half with mandatory new contributions from individuals and half with revenue diverted from the trust funds. The accounts are 3 percent of earnings, so the mandatory new contributions equal 1.5 percent of covered earnings.

Our plan would end the practice of using Social Security surpluses to fund general government operations. Thus, so long as Social Security surpluses exist, they would be directed to the personal retirement accounts and the required individual contributions would be less than 1.5 percent of payroll. For example, in 2008 the trust fund contribution rate would be 2.30 percent of payroll and the individual contribution rate would be 0.70 percent, in 2014 the trust fund contribution rate would be 1.94 percent of

---

[4] We recognize that the choice of an EEA involves balancing the well-being of myopic individuals who claim benefits too soon (and are therefore helped by an increased EEA) against the well-being of individuals for whom it is optimal to retire before the EEA and who are liquidity constrained. 65 is the age at which benefits were first available in the first two decades of Social Security's existence, and recent research indicates that the typical 69 year old is at least as healthy as a 62 year old was in 1961 – the year that men first became eligible for Social Security benefits. Therefore, we believe an increase in the EEA is likely to result in a net increase in well-being.

payroll and the individual rate would be 1.06 percent. Starting in 2018, the long run position is reached with 1.5 percent from the trust fund and 1.5 percent from individuals.

Raising the Taxable Maximum

A bit more than two-thirds of the 1.5 percent of payroll diverted from the trust fund is replaced by gradually restoring the percentage of earnings that is subject to the OASDI payroll tax to 90 percent (where it was in 1982) and maintaining it at that level thereafter. This increase in the taxable maximum would be phased in between 2008 and 2017. The new long run taxable maximum is equivalent to $171,600 at today's wage level.[5] The maximum level of earnings to be included in benefit calculations remains the maximum taxable earnings in current law—workers receive no incremental benefits from the increase in maximum taxable earnings.

III. Mandatory Personal Retirement Accounts

In order to keep total expected retirement benefits at levels comparable to those specified in current law, the LMS plan establishes personal retirement accounts equal to 3 percent of taxable payroll (using the current-law maximum as the cap).

The investment options for PRAs are designed to limit administrative costs and the risks to investors. PRAs would be invested with one of 15 private fund companies certified by the government to be eligible to receive PRA deposits. Each of these fund companies would be required to offer 5 broadly diversified investment options, patterned after the Federal Employee Thrift Savings Program. A central clearing house would handle transactions. Social Security actuaries estimate that administrative charges associated with PRAs would be approximately 30 basis points per year.

All payments from PRAs would be paid as annuities, which would initially be required to be fixed, inflation-indexed annuities provided by the Social Security Administration as part of a beneficiary's regular Social Security benefit. Full annuitization by age 68 is required, but beneficiaries can choose to spread annuitization between 62 and 68 if so desired. Married beneficiaries would be required to purchase joint and two-thirds survivor annuities. Annuities would be 10-year certain annuities to provide payouts to heirs of those who die soon after annuitization. The total balances in the accounts of the two spouses in a married couple would be split equally in the case of divorce.

Investment options are restricted and full annuitization is required because Social Security is meant to provide a basic level of retirement income support. For an average earner, the combination of the traditional benefit and PRA annuity will provide a replacement rate of about 35 percent. Retirement planners typically advise that retirees

---

[5] Our objective in raising the taxable maximum is to bring more revenue into the system in a way that reflects ability to pay. An alternative to raising the cap would be to tax all earnings above the cap at a lower rate – or to do some combination such as raising the cap (but not all the way to 90 percent of earnings) and then taxing earnings above the new cap at a lower rate. All three of us would be comfortable with any of these alternatives.

need an income level that is 70 to 80 percent of their pre-retirement earnings in order to maintain their standard of living. Thus, Social Security is designed with the expectation that the typical retiree will need to do additional saving (individually and/or through a pension plan at work) above and beyond Social Security. To the extent that retirees would like a different mix of investments or a different stream of payments in retirement, they can achieve that through their non-Social Security investments.

The progressivity in our plan comes on the revenue side from raising the taxable maximum and on the benefit side from reducing traditional benefits by a greater fraction for high earners than for low earners. But because the PRAs in our plan are equal to 3 percent of a worker's earnings, expected benefits are higher—relative to currently scheduled benefits—for high earners than for low earners. For example, as Table I shows, total benefits (including both traditional benefits and payments from a PRA annuity) for a 2-earner married couple are 96 percent of present law scheduled benefits for a scaled low-earner, 102 percent of present law benefits for a scaled medium earner, and 109 percent of present law benefits for a scaled high earner. In viewing these numbers it is important to remember that they show only the benefit side of the equation. They do not reflect the fact that high earners under the plan are paying a disproportionate share of the new revenues. However, all three of us support the use of progressive matches to augment the personal accounts of low-income workers as long as a funding mechanism for the matches is identified. Thus, we would support, for example, integrating a paid-for Saver's Credit with Social Security PRAs so that low-earners would have their PRA contributions matched by the government. We did not incorporate such a provision in our plan because changes to tax policy outside of Social Security are beyond the scope of our proposal.

Table 1
Benefits as Percent of Present Law Scheduled Benefits, 2056
(Assumes Expected Yield on Mixed Portfolio)

	Traditional Benefit Only	Traditional + PRA Two-Earner Couple, Married	Traditional + PRA Two-Earner Couple, Widowed	Traditional + PRA One-Earner Couple
Low Earner	62.6	96.3	107.5	85.3
Medium Earner	56.2	101.6	116.7	86.8
High Earner	54.2	109.0	127.3	91.2

IV. Other Updates to the Traditional Benefit System

Our proposal calls for making three other changes to update the Social Security system. These additional changes were not incorporated in the Actuaries' estimates of our plan because they have a relatively small impact of actuarial balance but would have added considerable complexity of the Actuaries' modeling task.

First, we would adopt the minimum benefit provision included in Model 2 of the President's Commission to Strengthen Social Security. This provision provides a minimum benefit for workers who work a large number of years at low-wages.

Second, we would adopt the provision from the President's Commission to Strengthen Social Security that would guarantee a widow(er) 75 percent of the benefit the couple was receiving before the first spouse passed away. Poverty rates among widows are around 20 percent and this provision would concentrate extra resources on this high poverty population.

Third, we would reduce spousal benefits for those married to high earners. The current Social Security system provides higher spousal benefits for someone married to a high earner than for someone married to a low earner, implicitly placing more value on the work done in the home of people married to high earners than of people married to lower earners. We propose gradually moving to a cap on spousal benefits at 50 percent of the PIA of the average worker in the worker's cohort. This provision would help pay for the other two provisions.

ADVANTAGES OF THE LMS PLAN

Sustainable solvency is achieved – The Social Security actuaries find that actuarial balance would improve by 2.14 percent of taxable payroll over the 75-year projection horizon. The current Social Security deficit is 1.92 percent of payroll. Therefore, the changes in the plan would lead to a 0.22 surplus. Trust fund balances in the last year of the actuaries' projection period are positive and increasing.
(See http://www.ssa.gov/OACT/solvency/Liebman_20051117.pdf).

Table 2
Contributions to 75-year Actuarial Balance

Policy	Improvement in Actuarial Balance (% of payroll)
Raise Taxable Maximum	1.00
Change in Benefit Formula	2.08
Increase in Full Benefit Age	0.62
Diversion of Trust Fund Revenue to PRAs	-1.56
Total	2.14

Fiscally responsible plan – The plan puts great emphasis on fiscal responsibility **–** borrowing less from general revenues than any other plan that has been scored by the Social Security actuaries in recent years. Table 3 compares the LMS plan with other recent Social Security reform plan. The first column compares general fund transfers to the OASDI Trust Funds. This is one measure of how much a plan relies upon unspecified resources from outside of Social Security to bring the system into balance. The LMS plan does not rely at all on general fund transfers, and instead uses changes to benefits and revenues to bring Social Security into balance. The second column shows the sum of all Social Security cash-flow deficits. In years in which Social Security benefits exceed revenues, the shortfall must be made up by the general funds of the government either through reductions in other government spending, increases in taxes, or issuing additional debt. Paying all currently scheduled benefits would require the rest of the government to come up with $6,372 billion in funds over the next 75 years. Under the LMS plan this number is reduced to $1,456 billion. None of the other 18 other plans scored by the Office of the Actuary in the past three years has lower cash-flow deficits than the LMS plan.

Table 3
Comparison with Other Plans

	General Fund Transfers (Present Value 2005 Dollars) (1)	**Total Cash-Flow Deficits (Present Value 2005 Dollars) (2)**
Scheduled Benefits	**6,372 billion[a]**	**6,372 billion[a]**
LMS Nonpartisan Plan	**0**	**1,456 billion**
Kolbe-Boyd	824 billion[a b]	1,956 billion [b]
Shaw	4,817 billion[a b]	1,906 billion [b]
Ryan-Sununu	8,920 billion[a b]	9,891 billion [b]
Ball	0	1,972 billion[a b]
Hagel	3,778 billion [b]	5,423 billion [b]
Pozen	1,994 billion [b]	3,778 billion [b]
Graham	3,696 billion[a b]	4,109 billion[a b]
Diamond-Orszag	0	2,424 billion [b]

Source: Plan memos from SSA Office of the Actuary.
[a] Deficits continue beyond 75-year projection window. Numbers represent only 75-year deficits.
[b] Numbers in actuaries' memo converted to 2005 dollars using 5 percent nominal interest rate.

Many practical reforms are included – The plan includes a number of sensible policies including an increase in the retirement age to reflect growing life expectancies; mandatory rather than voluntary accounts (which greatly simplifies the system, particularly by eliminating the need for benefits offsets); and required annuitization of accounts balances to help ensure that participants do not spend down their savings too quickly.

Economically beneficial – The plan has two features that are highly likely to increase net national saving. First, all projected future Social Security surpluses and all net new revenues are invested in personal accounts rather than the Social Security trust funds. Historically, it appears that when the Social Security system has been in surplus, the expenditures on non-Social Security programs have increased or tax cuts have been implemented to absorb the funds. Certainly, that is the case now, with an explicit deficit reduction plan that ignores the distinction between Social Security and other revenues. Second, the plan does not rely on borrowing to fund the personal accounts. Borrowing to fund accounts will not in general raise national saving. The plan also raises revenue in a relatively non-distortionary way: the individual worker contributions are deposited directly into the worker's personal retirement account.

Good for future generations – By phasing in policy changes more quickly than most other plans, the LMS plan spreads the costs across more generations, thereby decreasing the burden any one generation must bear. Also, by prefunding the Social Security system in an economically meaningful way, future generations would expect to see higher real wages due to the increase in the capital stock. The prefunding of accounts also helps to preclude the need to increase the current 12.4 percent payroll by up to 6 percentage points, as would be the case if the system remained pay-as-you-go at currently projected replacement rates.

Balanced compromise – The plan represents a number of balanced compromises on issues of solvency, adequacy, and funding. These compromises show that while differences exist, there is a range of Social Security reform options that can receive support across the political spectrum. Key differences – over things like the relative amount of taxes and benefits and about the amount of choice people should have in making their investments – are along a continuum and can be resolved through compromise.