

# How Social Security Reform Could Benefit Workers

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by Liqun Liu, Andrew J. Rettenmaier  
and Thomas R. Saving

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*Congress is once again considering changes to Social Security in an attempt to “save” the program. Social Security benefit payments have exceeded tax revenues since 2010; the funding deficit is growing and, barring reform, will continue to grow indefinitely. Higher tax revenues are necessary to fund benefits as they are currently calculated.*



Dallas Headquarters:  
14180 Dallas Parkway  
Suite 350  
Dallas, TX 75254  
972.386.6272

[www.ncpa.org](http://www.ncpa.org)

Washington Office:  
601 Pennsylvania Avenue NW,  
Suite 900, South Building  
Washington, DC 20004  
202.220.3082



When workers consider the retirement benefits they expect from Social Security they must also consider the taxes paid during their working years. Average-wage workers retiring today have paid more Social Security taxes than they will receive in retirement benefits, so their net benefits are negative. For future workers, who will have to pay higher taxes to finance the program's growing expenditures, net benefits will dip even lower.

The system is financed on a pay-as-you-go basis where current tax payments are transferred to current retirees. Changing demographics have resulted in a reduction in the number of workers supporting each retiree and a corresponding need for higher tax rates. The Social Security system cannot escape the ongoing demographic shift, but its share of the economy can be reduced and workers can escape the higher taxes necessary to fund the current program if they are willing to take lower Social Security benefits when they retire.

### **Balancing Benefits and Taxes.**

How do current and future workers' lifetime Social Security benefits and taxes compare under the current benefit structure, with the necessary tax increase to pay for those benefits,

and an alternative that scales back benefits such that they can be paid in the long run at the current tax rate?

There is a way to provide a common ground to explore the exchange between accepting lower benefits or paying higher taxes. Retaining the current benefit structure will require an immediate and permanent increase in the Social Security payroll tax of 3.3 percent. In contrast, a long-run balanced budget for Social Security could also be achieved by retaining the current tax rate, but making two benefit reforms: gradually raising the retirement age for workers who become eligible for benefits in 2023 and after, and making the benefit formula less generous for higher earning workers through progressive price indexing. Both political parties have proposed reforms with these attributes.

**Comparing the Current Program to a Reformed Social Security.** Our estimate illustrates that both the current program with the taxes necessary to close its financing gap (the baseline) and the reformed program produce comparable net results for workers across birth years and across income classes. [See the table.] For example,

- With the baseline program, average-earning men born in 1985 will have to pay 13.5 percent of their lifetime income in taxes and receive benefits equal to 9.6 percent of their income, resulting in a lifetime

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net tax of 3.8 percent (13.5 – 9.6).

- However, the same workers in the reformed program would pay a lower tax rate of 10.2 percent to receive reformed benefits of 8.2 percent, resulting in a lower net lifetime tax of 2.0 percent (10.2 – 8.2).

For very low-earning men, the reforms retain the current program’s progressivity. Specifically:

- In the baseline program, a very low-earning man born in 1985 will pay taxes equal to 13.5 percent of his lifetime income and receive benefits equal to 15.8 percent of income, resulting in positive net lifetime benefits equal to 2.4 percent of his lifetime earnings.
- In the reformed program, this worker would pay a lower tax rate of 10.2 percent of his income to receive reformed benefits of 14.5 percent, producing net lifetime benefits equal to 4.3 percent of his lifetime earnings.

The reformed and baseline programs produce similar lifetime progressivity due to the combination of policies necessary for each to achieve solvency. Under the reformed program, the gradual rise in the retirement age affects all workers regardless of income. However, most of the reform’s savings come through reduced benefits for higher earning workers.

In contrast, the baseline program retains the current benefit formula, but requires a substantial payroll tax increase to achieve solvency. For lower earning workers, these higher payroll taxes outweigh the lower benefits that are due to the higher

retirement age component of the reformed program.

### Why Reformed Social Security Is Preferable to the Baseline Program.

Finally, if the baseline and reformed programs are comparable in terms of net lifetime tax rates within income classes and birth years, is there a reason to prefer one to the other? The current retirement benefit structure could be fully funded with higher taxes to close the \$19.3 trillion shortfall (in present value). The funding gap could also be closed with the alternative. The reformed Old-Age and Survivors portion of the Social Security program would be about 25 percent smaller than projections under the program as currently structured (baseline). We suggest that the smaller reformed program is preferable, primarily for the following reasons:

- Given current debt levels along with ongoing and forecast budget challenges, reducing the size of the federal budget is critical in the long run.

### Projected Reformed and Baseline Lifetime Social Security Tax and Benefit Rates as Percentages of Lifetime Income

#### Single Men Born in 1985, Valued at Age 65

| Earnings Category             | Lifetime Taxes % | Lifetime Benefits % | Net Benefits % |
|-------------------------------|------------------|---------------------|----------------|
| <u>Reformed</u>               |                  |                     |                |
| Very Low                      | 10.2%            | 14.5%               | 4.3%           |
| Medium                        | 10.2%            | 8.2%                | -2.0%          |
| Taxable Maximum               | 10.3%            | 4.3%                | -6.0%          |
| <u>Baseline</u>               |                  |                     |                |
| Very Low                      | 13.5%            | 15.8%               | 2.4%           |
| Medium                        | 13.5%            | 9.6%                | -3.8%          |
| Taxable Maximum               | 13.2%            | 6.3%                | -6.9%          |
| <u>Reformed Less Baseline</u> |                  |                     |                |
| Very Low                      | -3.3%            | -1.3%               | 1.9%           |
| Medium                        | -3.3%            | -1.4%               | 1.8%           |
| Taxable Maximum               | -2.9%            | -2.0%               | 0.9%           |

Note: Estimates assume a 2.9 percent real discount rate, present values at age 65, benefit receipt beginning at scheduled or reformed normal retirement ages, and income adjusted life expectancies. See study text for further discussion.

Source: Liqun Liu, Andrew J. Rettenmaier and Thomas R. Saving, “Evaluating Social Security Reforms in the Age of Budget Deficits,” NCPA Special Publication, February 2014, Appendix Table I. Available at <http://www.ncpa.org/pdfs/EvaluatingSocialSecurityReformintheAgeofBudgetDeficits-web-31-2014.pdf>.

- Collecting the higher tax revenues necessary to retain the current benefit formula inevitably produces welfare losses.
- Reducing the scope of a pay-as-you-go financed retirement program will result in the real prepayment of retirement benefits, leading to greater investment and higher national income.
- The reformed program can be complemented with voluntary, individually directed personal retirement accounts.

*Liqun Liu is a research scientist, Andrew J. Rettenmaier is executive associate director and Thomas R. Saving is director at the Private Enterprise Research Center at Texas A&M University.*