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Commentary

THE BUFFIN FOUNDATION SOCIAL AND ECONOMIC DEVELOPMENT ISSUES

Financial Stability Strategy for Social Security

The main source of financing for the United States Social Security system is a fixed payroll tax that is currently set at the rate of 6.20% of covered annual earnings up to a limit of $127,200 and is payable equally by both employers and workers. However, a fixed payroll tax rate is not entirely appropriate for a system that is subject to secular demographic and economic factors that tend to increase the financing requirements for the payment of scheduled benefits over an extended period of time. This method of financing was adopted in an attempt to stabilize the incidence of the financing costs over a period of 75 years so as to produce equilibrium between the actuarial value of scheduled benefits and financing costs. In effect the financing method generates excess funds in the early years of the projection period that are offset by projected deficits in the later years. Regrettably, this approach to achieving stability does not work in the long run. It is not possible to set a permanent fixed rate of payroll tax to finance a Social Security system that, by its very nature, requires financing to be responsive to emerging secular changes, whether due to demographic or economic conditions. The economic costs as a percentage of covered payroll in the years beyond the initial 75-year projection period are greater than the established 6.20% stable payroll tax rate. These "out-years" should require a modestly escalating financing cost from year to year in order to maintain solvency and sustainability beyond 75 years. As a result of freezing the payroll tax rate at 6.20%, a moderate step-up in the financing costs will be required at some point before the accumulated surplus is dissipated. A recent World Bank paper stated "Sustainability may be compromised in the basic design of the program if the parameters lead to actuarial imbalance. The capacity to calculate and report both the short and long term financial status of the program is an important component and necessary to inform policy. This capacity, and even the basic information system to produce the required information, is often missing or underdeveloped." The fixed 6.20% payroll tax rate for the US Social Security system is such a parameter that compromises sustainability. The problem posed by the effect of long-term demographic and economic secular changes was neatly captured by the rhetoric of Winston Churchill in a 1946 debate about the cost of providing financial resources for the proposed United Kingdom National Health program when he opposed the legislation to introduce universal health care for the UK population on the grounds that it would require "ever-increasing Exchequer subvention". Although he was correct in identifying a probable escalation of costs over time, he was defeated on this point when a counter-argument was made that increasing cost trends are indeed affordable and can be readily met by workers' economic productivity. In the United States, action by Congress would be required to adjust the payroll tax rate. In some other countries, a system of automatic balancing adjustments has been established with the purpose of restoring financial balance by means of moderate changes to contributions and/or benefits without the need for legislative action. Failure to address this issue in the United States has resulted in a continuous erosion of the degree of solvency and sustainability of the system since 1983 when major reform measures were last introduced that included a projected 75-year period of actuarial balance between financial resources and projected outgo for benefits and administrative costs. John Turner, a Washington-based economist with the Pension Policy Center has produced an insightful paper with the title *Social Security Procrastination: A Behavioral Economics Response* that he presented earlier this month at a conference of the International Actuarial Association in Mexico. In this paper, he expresses the opinion that the US approach to Social Security policymaking needs to be reformed. He explains that policy inertia concerning Social Security occurs, not because of a lack of awareness of the problem or its consequences, but because of dogmas and strategies associated with getting desired reforms enacted consistent with purely political objectives. His major proposal is to introduce a default reform that would be triggered automatically if and when the solvency level (capacity to pay scheduled benefits) for the next fifteen years is projected at less than 100% and if Congress fails to act within one year. The effect of this automatic adjustment would be to restore 100% solvency for the next twenty years by means of a combination of increases to the payroll tax and reductions in scheduled benefits. The rationale for rebalancing over twenty years rather than a longer period of fifty or seventy-five years is that the degree of uncertainty and range of plausible outcomes for longer projection periods makes them unsuitable for policymaking purposes.

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