

# The Moynihan Social Security Proposal: Comments and Analysis

## ISSUE BRIEF #2

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New York senator Daniel Patrick Moynihan recently proposed a plan to enact a large cut in the Social Security payroll tax while significantly reducing benefits. This issue brief examines the proposal in greater detail, dividing the plan's main provisions into those that would strengthen the system's financial footing without curtailing benefits and those that would pose risks, particularly to the most vulnerable beneficiaries.

### **Changes That Would Strengthen Social Security's Financial Footing Without Curtailing Benefits**

**Increase Wages Subject to Tax.** The plan would increase the level of wages that are subject to the Social Security payroll tax from today's ceiling of \$68,400 to \$97,500 by 2003. The main rationale for the change, besides increasing the revenues available to pay for benefits, is that of all wages subject to Social Security payroll taxes, only 84.6 percent now fall below the ceiling compared to 90 percent historically. Under the plan, 87 percent of qualifying wages would be taxable. One risk of this proposal is that taxing a greater share of the earnings of the workers with the highest incomes could alienate those voters because their benefits would not rise commensurately. On the other hand, the change would make the payroll tax less regressive in that the share of earnings paid by high-income workers would rise relative to what low-income workers contribute out of their paychecks.

**Coverage of State and Local Employees.** The plan would extend Social Security coverage to all newly hired state and local employees. Currently, about 25 percent of state and local employees -- or about five million workers -- are not covered by Social Security, and the plan would gradually reduce that percentage to zero when fully effective. Phasing them into the program would be beneficial to Social Security's financing largely because, as with other groups when newly covered, revenues accrue for many years before benefits must be paid out. The 1994-96 Advisory Commission on Social Security unanimously supported this change.

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**Taxation of Benefits.** Under the plan, all retirees would be subject to income taxes on the portion of Social Security benefits they receive that exceeds what they contributed to the system. Currently, only half of benefits are taxable for beneficiaries whose total incomes exceed a threshold (\$25,000 for an individual; \$32,000 for a couple). Because federal income taxes do not apply to very low income households, this measure would not adversely affect the most vulnerable elderly. Middle-income retirees whose benefits significantly exceed what they contributed, however, could face a large increase in their taxes.

### **Changes That Pose Risks To The Most Vulnerable Beneficiaries**

**Adjusting for the Cost of Living.** The plan would cut benefits by subtracting one percentage point from the cost of living adjustment, which increases benefit payments at the rate of inflation as measured by the consumer price index. This proposal is based on arguments by some economists that the consumer price index overstates changes in the cost of living. But that analysis has been the subject of much controversy, with other economists observing that while inflation indeed has been overstated with respect to some products and services, it has been understated in others.

The low-income elderly would be especially vulnerable to a reduction in benefit increases below the measured inflation rate. Forty percent of all elderly rely on Social Security for 90 percent or more of their income. Twelve percent of elderly Americans already live below the poverty line and 18 percent live below 125 percent of the poverty line. For these seniors, every dollar counts, and it is they who would be at greatest risk.

Also, elderly Americans spend much larger shares of their incomes than the rest of the population on health care, which has had a far higher inflation rate than the consumer price index itself. Medical costs not covered by Medicare or other insurance plans now account for more than 20 percent of personal expenses for all seniors (that percentage is even higher for those below the poverty line), and Social Security adjustments over the past fifteen years have not reflected the full extent of this increasing burden. While the rise of health care costs has recently slowed, inflationary pressures in this area are likely to remain acute. Although the elderly spend less than younger Americans on expenses such as housing that can be subject to high inflation, studies show that on balance the elderly face more rapid cost increases due to their greater consumption of health care services.

**Emptying the Trust Fund.** The plan calls for a reduction of the payroll tax from today's 12.4 percent to 10.4 percent beginning in 2001. Then, starting in 2025, the rate would return to

12.4 percent until 2045, at which point it would begin a climb that would reach to 13.4 percent by 2060. Payroll taxes would be cut initially because the current higher rate is not needed to fund a system that now runs a surplus.

Reducing the payroll tax would significantly lighten a financial burden that for many low- and middle-income households outweighs the federal income tax. But the consequence of curtailing the payroll tax without replacing the revenue from another source would be the depletion of the trust fund earmarked for Baby Boomers retiring in the next century. Currently, the excess of payroll taxes contributed by today's workers over benefits paid to retirees is invested in U.S. Treasury securities. The government uses that surplus to pay for current expenses, but owes the money to the trust fund just as it guarantees payment to everyone who holds other Treasury notes and bills.

Surpluses produced by the current payroll tax rates that go into the trust fund create important breathing room for the system. Under current projections, the trust fund will start to decline around 2022, as Baby Boomers begin drawing their benefits and outlays exceed revenues. The trust fund is then projected to be depleted by 2032. The notion of saving extra money today to meet these lean times was a central element of past reforms. Because much of the surplus from today's payroll taxes are coming out of the wages of Baby Boomers -- the same group that will be drawing on the trust fund later -- building up the trust fund can be defended from the standpoint of fairness. In essence, the trust fund is partly functioning as a mandatory public saving mechanism for Boomers--and for the country.

**Will This Nest Egg Hatch? Voluntary Savings Accounts.** The plan represents a step toward privatization of Social Security in its attempt to transfer a portion of current payroll tax into personal savings accounts. Specifically, it calls for voluntary personal savings accounts, which workers could finance with proceeds from the 2 percent payroll tax cut. Workers do not have to participate in this program and instead could take the employee share of the tax cut in the form of higher take-home pay. In effect, the plan seeks to shift the surplus payroll taxes that are now going to the trust fund into a private program for increasing household savings. Workers would have the option of contributing to a fund administered by a federal board or a privately managed investment account like an Individual Retirement Account.

If current saving trends are any indication of future behavior, many workers would choose not to participate in the voluntary account program and would spend the money instead. The plan thus would replace a mandatory mechanism for placing savings in the trust fund with a mechanism that does not guarantee a comparable level of savings.

**Winners and Losers.** Making personal savings accounts a cornerstone of Social Security reform raises critical issues of fairness. If the plan were implemented, some Americans would invest their 2 percent of payroll tax wisely and do very well in the stock market. Other investors would be less lucky and get a poor return. Still others, as noted above, would not invest that money at all but rather spend it on current consumption. In all probability, an investor's success under a partially privatized system would correlate closely with education and income levels, further accentuating trends toward inequality. The plan would shift money from the shared risk/shared benefit inherent in social insurance.

**Fees and Commissions.** The money eaten up by the costs of administering private accounts is significant -- typically 10 to 15 percent, as compared to the 1 percent cost of administering Social Security. And with every worker having the option to set up a private savings account, the advertising battles Wall Street would wage for investor business would likely be intense. Many Americans might switch investors regularly, perhaps further increasing overhead costs, as has been the case in Chile's privatized system. The question left unanswered is whether government would regulate what might easily become a feeding frenzy.

**The Graying of the American Work Force.** The plan would further increase the retirement age, another move that would effectively cut benefits. Legislation passed in 1983 gradually raises the age at which retirees become eligible for full benefits, with the retirement age reaching sixty-seven for those born in or after 1960. The plan would accelerate the increases, moving the retirement age up to sixty-eight by 2017 and seventy by 2065. This change would seem to make sense given increasing life expectancies. However, it remains unclear whether the greater longevity of Americans translates into their longer vitality in the workplace. Certainly, the plan would adversely affect physical laborers for whom a longer work life is difficult, especially since there is no mention of loosening the requirements that now govern eligibility for disability benefits. In addition, given the shorter life span of African-Americans (and perhaps Hispanics as well), this aspect of the plan would negatively affect some groups more than others.

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In sum, Senator Moynihan's proposal offers some constructive suggestions but also contains a number of provisions that ought to be evaluated with great care.

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