



Fairly Understanding the Simpson-Bowles Social Security Proposal

Charles Blahous | November 11, 2010

Co-chairs Alan Simpson and Erskine Bowles of President Obama's Fiscal Responsibility Commission surprised the political world Wednesday when they publicly released their own (as opposed to a full commission) five-part plan for repairing the federal government's dire fiscal outlook. The five components of the plan included proposed reductions in discretionary spending, fundamental tax reform, targeted savings in health care entitlements, savings in other mandatory spending, and comprehensive Social Security reform.

The Social Security proposals in particular have produced the usual rash of practiced indignation. One union leader called the proposals "reckless attacks on working Americans," while another alleged that the chairs were telling working Americans to "Drop Dead."

Perhaps we should all catch our breath for a moment and examine what the co-chairs' proposals would actually do. What follows is my best objective analysis of their Social Security framework. In the spirit of full disclosure, I'll remind readers that two former bosses of mine, including co-chair Simpson as well as Senator Judd Gregg, sit on the commission.

Before I go into the details, let me cut to the chase: this is a serious, well-thought-out Social Security plan. It's not the proposal that I would draw up working alone, but it would vastly improve program finances in addition to several other aspects of Social Security.

As I explain in my book *Social Security: the Unfinished*

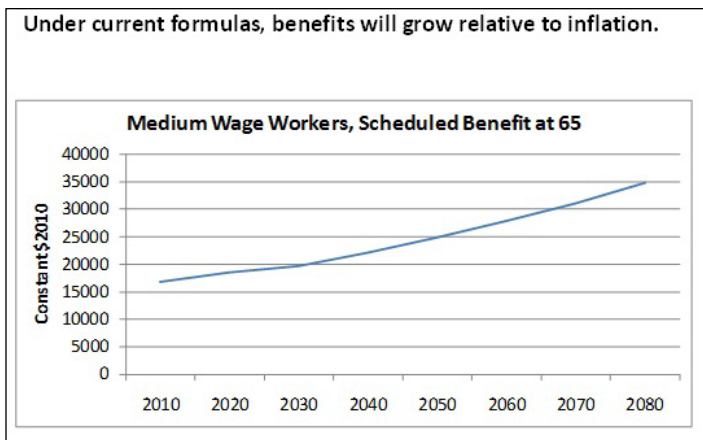
Work, Social Security proposals can be understood in relation to four fundamental value judgments; first, the balance between new revenues and cost containment in resolving the shortfall; second, the balance between pay-as-you-go financing and advance funding; third, the degree of progressivity (income redistribution); and fourth, whether the plan contains elements designed to address incentive problems under current law.

The commission plan makes minimal changes in the second area (pre-funding) and in the fourth one (incentives). True, the plan's provision to gradually increase the retirement eligibility ages would have a positive impact on labor participation, but otherwise the commission did not tinker with the benefit formulas to effect fundamental changes there. I will therefore focus on the two other criteria: first, the balance between cost containment and additional revenues, and second the degree of progressivity under the proposal.

Cost Containment vs. Revenues: We have already seen multiple press articles discussing proposed Social Security benefit "cuts." It's important that we not be careless with our language here. Surveys consistently show enormous public sensitivity to how changes to Social Security formulas are described, and in particular whether they are termed "cuts" or "reductions" in benefits. While I do not presume to tell anyone the correct way to think about Social Security benefits, it is important for all to be aware of the following facts:

1. Beginning in the 1970s, initial Social Security benefits began to be indexed to growth in the national average wage index, which generally rises faster than inflation. This can be seen on the graph below. When I typically make such a chart, I prefer to show benefits at the Normal Retirement Age (NRA), because age 65 has no particular salience given that it is no longer the NRA. I show benefits at 65 here because the circulated analysis of the Simpson-Bowles proposal also shows benefits at that age.

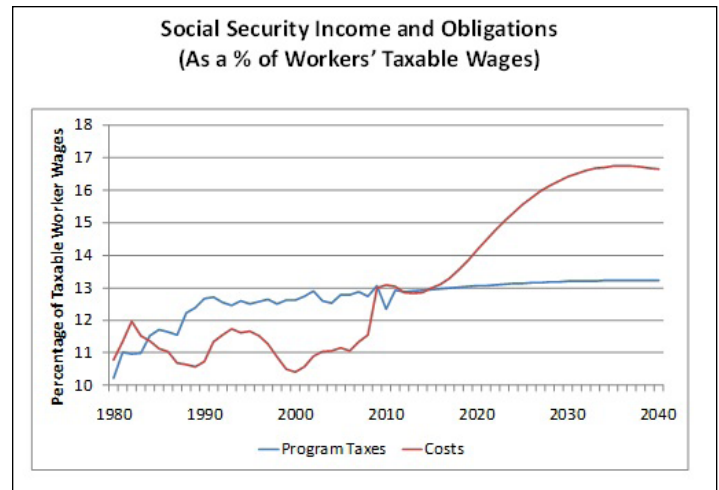
Under current formulas, benefits will grow relative to inflation



2. Maintaining this benefit formula without alteration into the future would cause program costs to rise enormously – from roughly 11.6% of each worker’s wage dollar in 2008 (just before the recent recession), to roughly 16.7% by 2035.

Social Security Income and Obligations rising

3. Alternatively, per-capita benefits could continue to grow in real terms even without a tax increase.
4. Bottom line: You’re either for changes to the benefit formula, or you’re for big tax increases on the next generation. If you oppose benefit



formula changes on the grounds that they are “cuts,” then you are for big tax increases. Period.

For Katie Couric to open the CBS Evening News using the terminology that the “commission” (inaccurate) had called for “deep cuts in Social Security” was thus in effect to join in the most extreme spin of Social Security reform opponents. But whether we call changes to the benefit formula “cuts” (because they would result in future benefits lower than now scheduled) or merely “slowing the growth in benefits” (because they would allow for benefits higher than today’s) the value choice we face is exactly the same. Let’s not allow our semantic choices to obscure the fundamental value judgment we must make about younger generations’ interests relative to our own.

The Simpson-Bowles framework chooses to fill part of the shortfall by increasing taxes and part by slowing the growth of Social Security benefits. The actuarial score released does not contain sufficient information to allow for a precise breakdown of the balance. My back-of-the-envelope calculations suggest that the answer depends on the year in question. The plan appears to rely more heavily on revenues prior to 2035, but by 2050 seems to rely much more heavily on cost containment.



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One item that increases the revenues in the plan is its provision to include newly hired state and local workers after 2020. This would in the near term tap more tax revenue for the system and in the long run would obligate additional benefit payments. Net, this provision does not contribute to long-term Social Security sustainability. If it were dropped (as I would recommend), then the plan would tilt in the direction of cost containment over almost any time period measured.

The biggest cost-saver in the plan is its proposed change to the “bend point factors” in the benefit formula. The Social Security benefit formula is built on a set of progressive marginal rates, somewhat like marginal income tax rates except in reverse. The current benefit formula’s benefit earnings brackets are 90% (on the low-income end), 32%, and 15% (on the high-income end). Under Simpson-Bowles, these three regions would be changed into four: 90%, 30%, 10% and 5%. As should be obvious, most of the cost containment from this provision would occur on the high-income end. The plan also contains some benefit increases for low-income workers and for the most aged, which I will discuss later.

The plan would also index Social Security’s early and normal retirement ages to life expectancy after 2022 to maintain a constant ratio of retirement years to working years going forward. In effect this means that each eligibility age would rise by one month every two years. This is hardly a sudden change. It’s actually a far more gradual rate of increase – about one-fourth as fast – than the one just phased in during the last decade.

The plan would shift to the use of the “chained CPI” to calculate Social Security COLAs. This is estimated to shave roughly 0.3 points off of annual COLAs based on what is believed to be a current methodological

overstatement of inflation. This recommendation would be applied across the board -- in every area of spending and revenues -- not just to Social Security.

On the tax side, the proposal would gradually raise the cap on taxable wages through 2050 to cover 90% of all national wages. This would increase the program’s revenues but would also increase the total payments going out (because all contributions to Social Security earn benefits). If 90% of wages were subject to tax right now, the cap on Social Security wages subject to tax would be at roughly \$170,000-\$180,000 (precise estimates vary) instead of its current \$106,800.

In my perfect world, we would fix Social Security without a tax increase. But if new revenues are necessary for a bipartisan solution, a better option might be to limit the tax preference for employer-provided health insurance – something the co-chairs do list as an “alternative option.” The co-chairs deserve credit for at least not increasing the cap right away, instead phasing it up over time as needed to pay benefits so that it doesn’t finance unrelated federal spending in the meantime.

Given the plan’s benefit increases, increase in the tax cap, and inclusion of state and local workers, overall cost containment under the plan is somewhat less than I personally would aim for. But the inclusion of state and local workers is somewhat superfluous to the plan’s fiscal aims, and if it were dropped the proposal would make great progress in averting the projected cost explosion.

One reason the plan would be such an improvement from the standpoint of fiscal conservatism is that continued delay in correcting the Social Security imbalance is incredibly costly. Every year that a new cohort of retirees hits the rolls, their benefits become politically inviolate. Moreover, because

each cohort's benefits are generally higher than the one before, the minimum politically acceptable level of subsequent benefit payments rises as well. In short, the longer that time goes by, the greater the share of the problem inevitably solved with large tax increases. Under any reasonable expectation, the level of additional tax revenues under this plan is substantially less than would be required if action on Social Security were delayed for several more years.

Progressivity and Income Redistribution: The Simpson-Bowles plan is a progressive one. In addition to the progressive bend point factor changes, the plan would create an increased minimum benefit to ensure that no one retires into poverty after a full working career. The best way to design such a provision is to have the new minimum benefit phase upward with years of earnings so that it doesn't create a disincentive to work. Information passed from the commission suggests that this is indeed how this provision is designed.

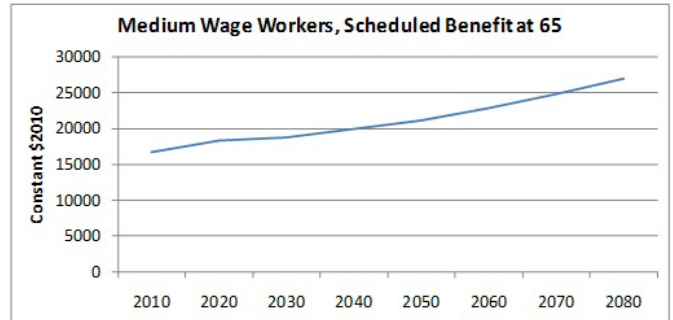
The plan also contains a provision to increase benefits for those who have been eligible for 20 years. This is designed to address the risk of the oldest-old outliving their savings and falling into poverty.

Put these various provisions together, and Simpson-Bowles is highly progressive. The medium-wage earner would still see substantial real benefit growth over the long-term, as shown on the opposite chart.

On the lower-income end, the rate of benefit growth would be far *faster* than shown in the chart. In fact, benefits for the lowest-income quintile would actually grow faster under Simpson-Bowles than they would even if taxes were raised substantially to finance the currently-scheduled benefit formula.

Reasonable people can disagree on the optimal Social Security plan. It is, however, ridiculous to

Under Simpson-Bowles, benefits still grow relative to inflation.



allege that the Simpson-Bowles outline represents an attack on working Americans. Retirement income security for low-income workers would be enormously greater under Simpson-Bowles than under current law: first because it would increase their benefits outright, and second because it would eliminate the threat of benefit reductions that would persist under the status quo.

Big-picture and presentational issues: The Simpson-Bowles proposal was clearly designed to pre-empt some of the attacks made on the commission. They make a point, for example, of saying that Social Security must be balanced for its own sake and is not being asked to contribute positively to the balance of the unified federal budget. The commission's critics would do well to show equal concern for Social Security's sound financing by offering their own alternatives for sustaining the program.

The proposal was clearly also designed to achieve the simultaneous goals of balancing system finances and strengthening protections for the most vulnerable. I'm pleased to see that some attention was also given to intergenerational fairness, by phasing in changes at a rate that reduces some relative intergenerational inequities under current law.

The Simpson-Bowles framework cannot claim



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perfection, but what proposal can? If I were given latitude to alter it, I'd eliminate the provision bringing in state and local workers and I'd search for a replacement for the provision raising the cap on taxable wages. But those who urge the outright defeat of the proposal should either provide an alternative that would achieve as much, or else explain to the rest of us why they are content to extract such a cost from our children and grandchildren as is looming under the status quo.