

Evaluating President Bush's Social Security Reform Proposal

Jason Furman
 NYU Wagner
 June 2005

Brief Overview of Social Security

Payroll tax rate: 12.4%

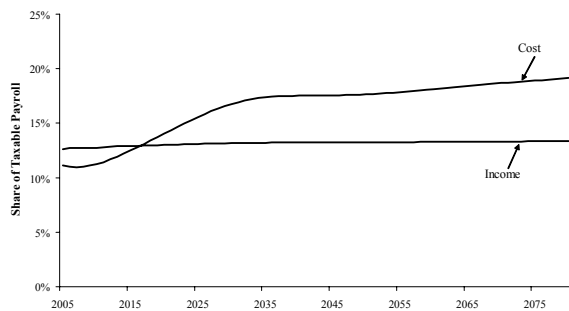
Benefits: Retiree, survivor, disability, dependent

Replacement rate: 24% - 60%

Solvency

- 75-year shortfall is 1.92% of payroll (0.65% of GDP)
- Infinite-horizon shortfall is 3.5% of payroll (1.2% of GDP)

Social Security Outlook



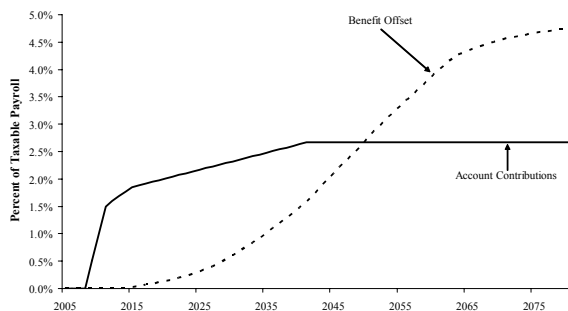
President Bush's Proposal

(1) Voluntary Individual Accounts

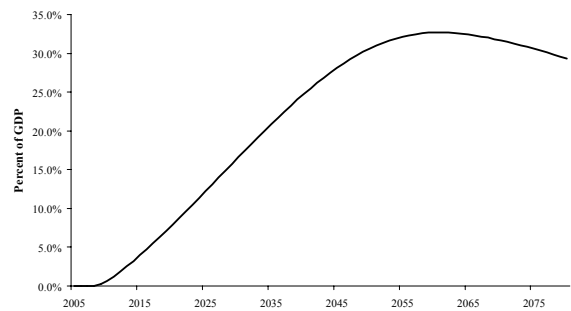
- 4 percent of payroll when fully phased in
- Benefit offset: Every dollar contributed to the account reduces defined Social Security benefit by one dollar in present value

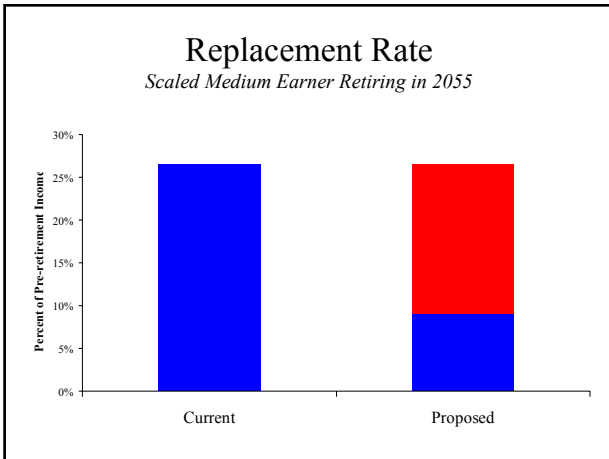
(2) Reduce Replacement Rate: "Progressive Price Indexing"

Macroeconomic Features of Accounts



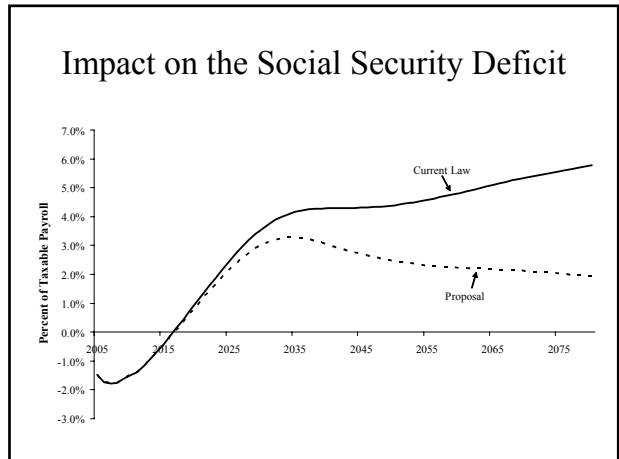
Impact on the Debt





- ### Impact on Individuals
- Rational choice model
 - People who are not equity-constrained will not participate
 - Equity-constrained could gain from diversification
 - Behavioral model
 - More equity exposure / risk facing individuals
 - Less savings if accounts are perceived as net wealth

- ### “Progressive Price Indexing”
- Reduce replacement rates
- Top 1 percent frozen in real terms (price indexing)
 - Bottom 30 percent same as current law (wage indexing)
 - Convex combination for those inbetween



Impact on Replacement Rates

	Current Schedule	2045	2075
Low (27th percent.)	49%	49%	49%
Medium (55th percent.)	36%	30%	26%
High (85th percent.)	30%	23%	18%
Maximum (99th percent.)	24%	17%	12%

- ### Solvency Goals
- 1983 Reforms:
- Projected to restore 75-year solvency (2060+)
 - 1983 projected balance 2005-79: +0.15% to -0.79%
 - Today’s projected balance 2005-79: -1.92%
- Lessons:
- Sustainable solvency
 - Robust solvency

Coping With Uncertainty

Two principal sources of uncertainty in a PAYGO system:

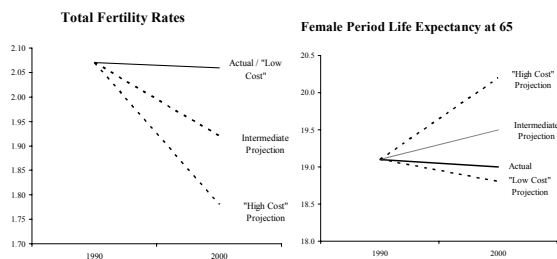
- Productivity Growth
- Demographic Uncertainty

PAYGO Balance

$$\overline{Income}_t * Tax_t * Workers_t = \left(\frac{\overline{Benefit}_t}{\overline{Income}_{t-1}} \right) * \overline{Income}_{t-1} * Beneficiaries_t$$

$$Tax * (1 + g) * \left(\frac{Workers}{Beneficiaries} \right) = Replacement Rate$$

Demographic Uncertainty



Alternative Outcomes in 2080

	Working age (20-64) per Retiree age (65+)	PAYGO Tax Rate (OASI Only)	PAYGO Replacement Rate
2005	4.9	10.6%	42.2%
Low	3.0	12.0%	31.0%
Intermediate	2.3	15.7%	23.6%
High	1.7	21.3%	17.4%

Proposal: Dependency Indexing

What To Index?

- Can do a combination of payroll taxes and benefits

How To Handle the Transition?

- Can directly index parameters
- Can pick a transition path, dependency index deviations from initially projected dependency rates

Sample Plan

Base Provisions

- Raise taxable maximum and charge a legacy tax of 2.9 percent above maximum
- Tax fringe benefits at 6.2 percent
- Include State & local workers
- Enhance minimum benefit

Dependency Indexing

- Divide equally between payroll tax and benefits

Cost and Income Under Plan

