A New Vision for Social Security

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Social Security is the largest domestic federal program. It is funded by the largest tax paid by most workers, and is the largest source of income for most retirees. The program provides benefits to the elderly, to the disabled, and to the families of eligible workers who have died, and so is relied upon by some of the most vulnerable people in our society.

It is also growing insolvent. As currently designed, the program has practically no chance of remaining financially sustainable in the coming decades. It is therefore incumbent upon today’s policymakers to address Social Security’s fiscal problems and to ensure the program can provide what its very name promises: security, or at least the confidence that benefits that are promised can and will be delivered.

But the debate surrounding the reform of Social Security has been just as discouraging as the program’s financial outlook. Most elected Democrats are content to praise Social Security while doing little or nothing to save it. In 2005, when President George W. Bush was promoting a plan to fix the program, minority leader Nancy Pelosi was asked when House Democrats would put forward their own proposal. Pelosi’s answer was: “Never. Is never good enough for you?” As Social Security’s financial condition has worsened, Pelosi and her party have kept their promise. But denial and hope won’t save retirees and the disabled from a 25% benefit cut when Social Security becomes insolvent in the early 2030s.

Republicans, by contrast, have been keenly interested in Social Security reform since at least the mid-1990s, but they treat Social Security as a budget problem to be solved rather than a program to be improved

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and saved. Their reform ideas are often indecipherably complex (think of Bush’s “progressive indexing”), and many Republican lawmakers seem unable to explain why we have a Social Security program in the first place and what we want it to accomplish.

What Republicans need, in other words, is a compelling vision for Social Security reform— one that is consistent with principles of limited government and individual responsibility. By articulating the case for a strong Social Security program, highlighting the ways in which the current system falls short, and outlining broad policy changes to make Social Security effective and financially sustainable, reformers can begin to develop a constructive, conservative approach to preserving and improving Social Security.

THE FINANCING CHALLENGE

Over the next decade, the Social Security program will provide about $984 billion more in benefits than it will collect through the payroll tax that is intended to fund it, according to the 2013 report of the program’s trustees. Social Security can continue paying benefits for now because it ran a surplus over the past three decades; the extra funds were lent to the Treasury for use on other federal programs, and as those loans are repaid, they can be spent by Social Security. But the deficit cannot be patched up this way forever, and the longer we wait to address the program’s approaching insolvency, the more difficult any attempts at reform will become.

The program’s trustees report that, over the long term (by which they mean the next 75 years), Social Security will be underfunded by an astonishing $9.6 trillion. To make Social Security “sustainably solvent”— meaning solvent over that 75-year stretch, and in good financial health at the end of that period— would require an immediate and permanent payroll-tax increase of 4% of wages. This means that the average Social Security payroll-tax bill would increase by 32%. Alternatively, we could reduce benefits immediately and permanently by around 28%. If we choose to put off these changes— as Congress has done for decades— the tax increases or benefit reductions required to keep the program sustainable will only grow larger.

Social Security’s financing problems are portrayed as minor relative to those of Medicare and Medicaid, and it is true that our health-care entitlements face even larger long-term funding shortfalls if they are
not reformed. But over the past four years, Social Security’s costs have risen both more in dollar terms and faster in percentage terms than Medicare’s. And while some modest measures have been put in place to restrain Medicare cost growth, the long-term outlook for Social Security has grown increasingly dire: Since 2008, Social Security’s 75-year shortfall (measured against its tax base) has risen by 57%. Measured in dollar terms, it has risen by more than 70% in that time.

But adjusting tax and benefit levels to avoid insolvency is not the only task facing Social Security reformers, and perhaps not even the most crucial one. Social Security is a pay-as-you-go program that transfers resources from working-age Americans to retirees and other beneficiaries. As such, it depends upon a strong economy to ensure that its promises to retirees will be kept, especially as the population ages and the ratio of workers to beneficiaries declines. Yet Social Security sabotages itself. It discourages work, diminishes saving, penalizes delayed retirement, and even lowers the birth rate—all of which undermine the health of the economy and its ability to support Social Security and other entitlement programs. Thus Social Security reform is not merely an accounting exercise of matching revenues and outlays (as even many conservatives imagine it to be), but a matter of first-order importance to the federal budget and the economy as a whole.

The success of even a well-designed reform, however, depends upon how the matter is framed. President George W. Bush, for instance, was well-versed in Social Security policy and had the political courage to attempt a serious reform. But his administration (in which I worked) presented the challenges facing Social Security in technical rather than human terms. For example, the idea of “progressive indexing”—which was central to the Bush reform effort—proposed complicated, incremental changes to the Social Security benefit formula. For the bottom third of the earnings distribution, the reform would have maintained the current benefit formula, which is tied to the growth of wages. The benefit for the very highest earners would have grown with prices (and thus at a slower pace); beneficiaries in the middle, meanwhile, would have been offered a mix of the two. The complexity of the idea made it difficult to communicate, and the administration never explained its proposal in the context of the pressures facing low-income seniors. To this day, even those media outlets most friendly to reform often misunderstand the nature of such proposals.
Bush’s failed plan is a good example of the usual reform approach. Typically, reformers begin with the current program and suggest small changes to various aspects of the tax and benefit formulas that, over time, will help restore solvency. But because almost no one understands how the current benefit formula works, these proposals are inevitably indiscernible to a skeptical public. Even the reformers themselves are rarely able to explain how their technical fixes will result in a stronger and more effective program for the future.

A better approach would start at the end and work backward. First, reformers should decide what they want Social Security to look like decades from now; then, they should design the technical changes that get us from here to there incrementally. The whole process should begin with some very basic questions: What are the goals of Social Security, and how might they best be achieved?

The program’s goals can be described as a combination of two important purposes: saving and redistribution. Social Security first requires that all workers give up a portion of their current earnings in return for some guarantee of income in retirement—effectively mandating a form of saving. The rationale for this forced saving is straightforward: in any group of individuals, there will be some portion who lack the foresight to plan for the future. In a 21st-century democracy, individuals who reach retirement without a nest egg won’t be allowed to starve. Mandatory retirement saving thus protects not only the short-sighted individuals themselves but also the more responsible individuals who would be forced to bail them out.

Second, Social Security supplements the incomes of individuals who could not provide a decent standard of living for themselves in retirement even if they saved regularly. The program gives money to low earners, the disabled, and surviving family members of deceased workers. This aspect of Social Security can be seen as welfare, redistribution, or insurance.

Social Security accomplishes this dual mission through a single benefit formula that is both earnings-based and redistributive. Benefits are calculated as a progressive replacement of average lifetime earnings. Each person’s retirement benefit is determined by first taking into account two factors: the age at which he chose to retire (those who retire early, starting at 62, receive lower benefits than those who wait until the normal retirement age, which is now 66) and a measure of how much he earned during his working years (which indicates the amount he paid into the
system through Social Security taxes). This earnings measure is based on the average of the 35 years in which he made the highest amount in covered wages (that is, pay that was subject to the payroll tax). This average is adjusted for wage growth and then divided by 12 to yield a monthly amount. Redistribution comes into play as that monthly amount is then inserted into a progressive benefit formula. This formula, based on a retiree’s average pre-retirement earnings, calculates benefits such that Social Security replaces a larger proportion of the average earnings amount for a retiree who had lower earnings than it does for one who had higher earnings. This means that higher earners receive larger absolute benefits, but low earners enjoy higher “replacement rates” — that is, higher benefits relative to their prior earnings or contributions. In this way, Social Security endeavors to balance “equity” and “adequacy.”

A reformed Social Security program should continue to serve these two purposes and balance these two goals. The key, however, is to ensure that it does so while avoiding the significant shortfalls and downsides of today’s system.

Falling Short

The typical fiscal conservative’s approach to Social Security reform focuses entirely on solvency and the debt burden that an unreformed program will impose on future generations. The typical response from the left argues that these financial burdens are either uncertain or easily affordable. Both sides of this debate miss the point.

Financing issues obviously are important, but they are not necessarily the problems that should capture most of reformers’ time and attention. Social Security has some more fundamental problems, and addressing those would also make the funding challenge easier to tackle. Simply put, in an aging population, smaller numbers of workers must support larger numbers of retirees. The only way to avoid a zero-sum game in which different generations fight over limited resources is to build a stronger economy. But Social Security consistently makes our economy weaker.

It does so first by discouraging work. According to recent polls, some 60% of working-age Americans do not believe they will receive Social Security benefits when they retire. Not surprisingly, such workers perceive their Social Security contributions as simply a “tax” that reduces their income without offering them much in return. No one works less because
part of his paycheck is diverted into his own 401(k) retirement savings plan, because he knows that money will be returned to him in retirement. But many people do not feel the same way about Social Security taxes. The result is that Social Security payroll taxes tend to reduce an individual’s willingness to work in ways that contributions to a private pension or personal savings account do not. For example, a 2008 study found that raising the payroll tax from 12.4% to 15% would reduce annual hours worked by around 6%, implying that higher rates would not increase Social Security revenues nearly as much as the rate increase would suggest.

And the higher we raise taxes, the more of a drag on labor supply Social Security will become. For instance, the Congressional Budget Office found that one prominent proposal from MIT economist Peter Diamond and former Obama-administration budget chief Peter Orszag—a proposal composed of roughly 90% tax increases and only 10% benefit reductions—would permanently reduce the size of the economy by 1.5% to 1.7%. In today’s terms, this reduction would amount to $267 billion annually, meaning that, every year, each American would be $846 poorer. That’s not the cost of directly paying the higher taxes in the Diamond-Orszag plan: It’s the reduction in per-capita income—the income out of which Americans would then have to pay for those tax increases. According to the CBO, these results come about because the tax increases included in the plan would reduce incentives to work, and the higher benefits paid by the plan (relative to a proposal that didn’t raise taxes) would reduce incentives to save.

This is the second major drawback of today’s Social Security system: The program as it is currently designed undermines personal saving. Those Americans who do believe they will receive all or most of the Social Security benefits they have been paying for will tend to save less for retirement. Social Security benefits plainly substitute for other forms of retirement saving, such as individual retirement accounts (known as IRAs) or 401(k) accounts, in turn reducing the capital made available by such investment accounts to finance the factories, tools, and technology that workers need to raise their productivity and wages and increase the size of the economy.

Research by economists Orazio Attanasio of University College London and Susann Rohwedder of the RAND Corporation indicates that the portion of government pension benefits that constitutes mandatory saving is offset by lower personal saving on a roughly dollar-for-dollar
basis. Only the redistributive portion of the program—the benefits paid to low-income workers in excess of their contributions—is not offset. This is an enormously important finding: Social Security currently owes roughly $22 trillion in benefits that have been earned but not yet paid out. If even half that amount had instead been saved and invested in the private economy, the annual gross national product would be roughly $1 trillion larger.

The third major problem is that the program tends to induce workers to retire earlier—again undermining the economy. Back in 1950, the typical American claimed Social Security benefits at age 68 and lived to around age 76. Today, the typical American retires at age 63 and can expect to survive until age 83, meaning that person will spend roughly one-third of his adult life in retirement. Reversing this trend toward early retirement is perhaps the best solution to the fiscal pressures created by the aging of our society.

Consider that delaying retirement by just one year raises the typical worker’s total retirement-income replacement rate by around five percentage points, and that for low-wage workers, the replacement rate can rise by 20 points or more. Despite these benefits of waiting, however, Social Security still encourages workers to retire early. Because Social Security benefits are based upon the highest 35 years of earnings, a 36th year of work raises benefits only to the degree that earnings in that year exceed those in the least remunerative of the prior 35 years. Thus a typical near-retiree who works an additional year receives only around 2.5 cents in additional lifetime benefits for each dollar of taxes he pays into Social Security. Moreover, most women still receive spousal benefits based upon their husbands’ earnings; women who earn more by working longer do not receive increased benefits. As a result, Americans almost surely retire earlier than they otherwise would.

Social Security’s fourth major drawback is that it lowers birth rates. People who point to the program’s financial problems usually emphasize Baby Boomer retirements and increasing life spans. But the real trouble is on the other end of our demographic cycle: There are simply too few people being born now to sustain the program. If the average family today had three children rather than two, Social Security’s long-term financing problems would be cut in half. But Social Security itself appears to reduce the birth rate, with some studies concluding that roughly half of the reduction in fertility rates seen in developed countries since the
1960s is attributable to the increasing size of pay-as-you-go entitlement programs and the taxes needed to finance them. Raising children is expensive, and when high tax rates make parenting even less affordable, people are increasingly unlikely to have big families. Whether a country can increase its birth rate through public policy—and whether it should even try to—are controversial questions. Nevertheless, it is not unreasonable to suggest that Social Security reforms should be designed so that they are not unfriendly toward parents.

Fifth, Social Security is also failing in its basic safety-net function. Despite frequent claims that Social Security is the nation’s most effective anti-poverty program, it actually often fails poor seniors. The problem is not that Social Security is not generous enough, or even that it is not progressive enough. It is that, while the program is progressive on average, there can be massive variations in the benefits received by individuals who earned the same amount and paid the same taxes. For example, Social Security provides the average person at the 20th percentile of the lifetime-earnings distribution—people who are truly quite poor—with a replacement rate of 104% of pre-retirement earnings, which appears adequate. But that is an average figure. It includes about a tenth of this group who receive replacement rates of over 150%, but it also includes another tenth who receive replacement rates of less than 60% of their pre-retirement earnings. For low earners, Social Security is a social-insurance policy that may or may not pay off.

This inadequacy results in part from the fact that, while Social Security does redistribute from rich to poor, most of its redistribution has nothing to do with progressivity. For instance, Social Security massively redistributes from two-earner couples to single-earner couples and from workers who had long careers to those who had short ones. This does little to fight poverty, and it is certainly not fair. Such poor targeting of benefits helps explain why almost 9% of seniors live in poverty despite roughly $800 billion spent annually on Social Security benefits. More effective targeting of benefits could reduce poverty rates with no changes to the system’s overall progressivity or costs.

Finally, the program is simply very hard to understand. Though Social Security is supposedly structured like a straightforward defined-benefit pension program—which makes clear from the beginning what retirement benefits can be expected—Social Security benefits are far more complicated. The Federal Consumer Information Center calls
defined-benefit pensions “a predictable, secure pension for life,” saying that “workers are promised a specific benefit at retirement...[and] can know in advance what benefits they will receive.” But this description rarely applies to Social Security. The same factors that cause Social Security benefits to be so poorly targeted also lead the typical person to have almost no understanding of how his benefit is calculated and little ability to predict what his retirement benefit will be. A person who can’t predict his Social Security benefit can’t make informed decisions about how much to save on his own or when to retire.

The massive Health and Retirement Study conducted by the University of Michigan regularly interviews subjects across many years, making it possible to compare what workers thought they would get from Social Security to the benefits they actually received in retirement. Roughly one in four individuals near retirement could not even guess what their Social Security benefit levels might be. Of those who did make predictions, their guesses were often quite far off. The median person underestimated realized benefits by about 3%, but one-third of near-retirees overestimated their benefits by at least 10%, and a quarter overestimated them by more than 28%. One in ten retirees received benefits that were less than half the size they expected.

Put simply, many Americans have no idea what their Social Security benefits will be until their first checks arrive. It is difficult to see how this “predictability risk” differs from the market risk of 401(k)-style retirement accounts. Improved financial education is unlikely to fix this problem: The annual Social Security statement, which gives all Americans basic information about their taxes and expected benefits, seems not to have helped much. A better solution is to address the underlying problem by streamlining Social Security’s benefit structure so that it makes sense to ordinary Americans.

These six shortcomings of today’s Social Security program are enormous problems. But they also present an opportunity. Reforms that reduce the burdens that Social Security places on the economy, enhance the system’s social-insurance value, and simplify the benefit formula have the potential to generate better outcomes at lower costs.

A TWO-PART BENEFIT

A Social Security reform that addressed the program’s structural and fiscal problems would begin by transforming today’s complex benefit
formula into a two-part system consisting of a savings account and a flat universal benefit. Such a system could be implemented gradually—ap- plying only to new workers as they entered the work force, and so very incrementally and slowly replacing today's system without breaking any promises already made to working Americans.

First, everyone in this new system—rich and poor alike—would be given an opportunity and a strong incentive to save for retirement. Each worker would be enrolled automatically in an employer-sponsored retirement account such as a 401(k) or 403(b). Workers would contribute at least 1.5% of pay, matched dollar for dollar by their employers. Universal retirement savings accounts would allow Social Security to focus its efforts: If everyone saved as they should for retirement, Social Security could concentrate its resources on low earners who needed the program the most.

These universal accounts would take advantage of all that we have learned about how to structure retirement savings vehicles in recent decades. Enrollment would be automatic. While employees could withdraw if they chose, we know that auto-enrollment dramatically increases participation rates compared to plans that require affirmative choices by employees. All plans would have to offer a so-called life-cycle fund that automatically shifted from stocks to bonds as participants approached retirement. This life-cycle fund should itself be built upon low-cost index funds that track the stock and bond markets rather than make a costly and usually futile attempt to beat them. Finally, distributions from these accounts would be tax free (up to a limit) if converted to an annuity that provided a stable monthly income for life upon retirement.

Second, Social Security’s government-provided benefits would be transformed into a flat universal benefit to improve social-insurance protections for low-income Americans. Such a reconceived benefit would be based on the principle that, as a rich and fortunate society, we should not allow individuals to retire into poverty. Each American reaching the normal retirement age would receive a benefit set at the poverty thresh- old for individuals over age 65 (which today is about $920 per month).

The flat poverty-level benefit would be paid no matter how low the recipient’s earnings were in his working years or how spotty his employ- ment record was. This part of the reform would replace the redistributive aspects of today’s Social Security benefit formula, as well as the pure welfare function played by Supplemental Security Income, a separate
means-tested program that pays benefits to extremely poor retirees. The flat poverty-level benefit would by itself increase benefits for around a third of the retirees whose current Social Security benefits leave them below the poverty line. Over time, this flat benefit would rise with wages for new retirees, maintaining Social Security’s role as an anti-poverty program even as income levels increased.

The flat benefit and supplementary savings account would be designed so that, if individuals invested in safe government bonds, the total combined benefit would approximate both the generosity and the progressivity of today’s benefit formula. But unlike current law, under which benefits vary significantly even for individuals and households with the same lifetime earnings, the reformed plan would provide benefits that retirees could predict and rely upon.

Moreover, the combination of a flat benefit and universal savings accounts would present Social Security participants with a far simpler program. Because each retiree would receive essentially the same benefit from the government, knowledge of benefit levels would improve substantially. To aid participant knowledge, quarterly account statements could provide—as some 401(k) plans already do—an estimate of the monthly income that the account would be sufficient to produce at retirement.

Finally, this new two-part system would significantly reduce the economic drag imposed by the current Social Security program. The new system’s tax costs would decline over time as the flat benefit began to replace the more costly benefits promised under current law, reducing the current program’s disincentives to work. While workers would divert a portion of their earnings to the retirement accounts, these contributions would be more likely to be viewed as deferred compensation than as a “tax,” and so would be less likely to discourage work. Moreover, as universal savings accounts partially replaced tax-and-transfer benefits, the personal saving rate would likely increase, and with it investment and economic growth.

CARROTS AND STICKS

This restructuring would serve the two key goals of Social Security reform: universal retirement saving and the elimination of poverty in old age. But it could be supplemented by additional policies designed to encourage work and saving, facilitate longer work lives, and direct benefits
to the people who need them the most. To achieve these ends, reformers could offer workers a stick and two carrots—that is, one requirement and two inducements. These would be offered not only to new workers entering the work force, but also to many Americans already working and paying Social Security taxes.

First, reformers could gradually increase the early retirement age from 62 to 65 for workers retiring in the 2030s (people who are roughly 45 or younger today). This change would, understandably, be unpopular, as many people would not welcome delayed retirement. But there is a very good case for such a change: Even as life expectancies have risen and work conditions and health have improved, Americans retire much earlier today than they did half a century ago. Yet claiming benefits at 62 rather than waiting a few years to retire results in a serious penalty—a permanent 25% benefit reduction—leaving some individuals destitute when they are truly old. The point of preventing individuals from claiming early retirement is thus not to cut benefits—which would be approximately the same over the course of retirement—but to delay benefits and thereby increase them when they are needed the most.

For individuals who truly could not remain in the work force until age 65, Social Security disability benefits would remain available, while the eligibility age for Supplemental Security Income benefits would be reduced from 65 to 62. Together, these reforms would provide basic coverage for those who truly need it, while also encouraging those who can work longer to stay in the labor force. The Congressional Budget Office estimates that raising the early retirement age by two years—a smaller increase than the one proposed here—would increase annual gross domestic product by around one percentage point and federal revenues by around a quarter of that amount.

Second, reformers should eliminate the payroll tax on older workers. Those who delay their retirement continue to pay Social Security taxes but receive almost no additional benefits in return, giving older Americans further reason to quit the work force early. Eliminating the 12.4% Social Security payroll tax for all individuals aged 62 and older would get rid of this disincentive while encouraging individuals to remain in the work force and also making older workers more attractive to employers (since employers pay half of workers’ payroll taxes). Such a reform would certainly reduce Social Security revenues, of course, but it would offset some of that reduction by increasing other government
revenue. Near-retirees are particularly sensitive to tax rates, since they have the option of retiring if the incentives to continue working aren’t sufficiently attractive. Economist Eric French of the Federal Reserve Bank of Chicago projects that a 10% increase in after-tax wages beginning at age 62 would raise overall labor supply by 1.1%, which would raise federal income-tax and Medicare-tax revenue enough to offset roughly three-quarters of the static revenue loss to the government. If increased state income-tax revenues were included, the payroll-tax cut would essentially be self-financing. Thus, while eliminating the payroll tax for older workers would come at little net cost to the budget, the gains to individuals and the economy could be substantial.

Third, reformers should eliminate the Retirement Earnings Test, which reduces payments for people who claim Social Security benefits early but continue to work. Under the RET, benefits are reduced by about 50 cents for each dollar a beneficiary aged 62 to 65 earns in excess of around $15,000 a year. To beneficiaries, the earnings test appears as a 50% tax added on top of any other taxes they already pay. Not surprisingly, many individuals work until their earnings reach the RET threshold, and stop before they cross it.

Eliminating the RET would not actually increase federal spending: Under today’s system, when a senior reaches the normal retirement age, the RET is stopped and benefits are adjusted upward to compensate for any reductions in benefits during early retirement caused by the RET. Over the course of a typical retirement, total benefits are about the same with or without the RET. The problem, however, is that most people are not aware of this fact, and the Social Security Administration and financial advisors often do a poor job of explaining it. Indeed, University of Virginia economist Leora Friedberg estimates that eliminating the RET would raise labor supply among early retirees by 5.3%, a significant increase for a policy change with no long-term budgetary cost.

FINE-TUNING THE SYSTEM

Three final reforms would help complete this approach to fixing Social Security by addressing the remaining drawbacks of today’s system and building on the strengths of the redesigned two-part core benefit.

First, the new system would allow for a rethinking of cost-of-living adjustments. Many reformers have suggested reducing the program’s annual adjustment (or COLA) by linking it to the so-called “chain weighted”
Consumer Price Index. Simply put, while the conventional CPI—which currently determines COLA adjustments—assumes an unchanging basket of goods, the chained CPI is designed to account for how buying habits change as prices rise or fall. There is little dispute that the chained CPI is an improved measure of general inflation. But that does not make it the best measure for determining Social Security COLAs.

In fact, a case can be made that COLAs should rise faster than inflation. To be most effective, Social Security should focus benefits when and where they are needed the most. A move to base COLAs on the chained CPI would actually do the opposite: It would cut benefits (relative to today’s system) for the oldest and poorest retirees, who have little ability to return to work, while leaving untouched younger retirees whose 401(k)s are full and who could—and probably should—keep working.

A better policy would reverse this approach. If COLAs grew at a rate one percentage point higher than inflation, by the time retirees turned 80, their benefits would be 20% higher in real terms than they were when the retirees were 62. By age 95, benefits would be 39% higher. This makes sense, since people tend to run out of their private savings when they reach extreme old age. And these benefit increases would be affordable in the reformed system envisioned here because the universal flat benefit would be considerably less expensive over time than the current program.

Second, reformers should pursue a “family friendly” payroll-tax cut to offset Social Security’s effect on family size. Larger families would significantly benefit Social Security’s finances. But raising a child entails hundreds of thousands of dollars in costs, from birth through college. To compensate parents for their efforts and expenses, a family-friendly payroll-tax cut would reduce the 12.4% Social Security payroll tax by two percentage points for each child under age 18. Such a reform might have the side effect of raising fertility rates and thereby reducing Social Security’s deficits over the long term. For example, an explicitly pro-fertility tax credit introduced in Quebec in 1988 is estimated to have raised birth rates by as much as 25%. A similar increase in the United States would raise the fertility rate from its current 2.0 to around 2.5, such that the tax cut would more than pay for itself.

In modeling the effects of such a reform, I have assumed a far smaller increase, with birth rates rising to 2.15 children per woman. To maintain revenues under such a scenario, the basic payroll-tax rate would
need to rise by 1.3 percentage points, split evenly between employers and employees. Individuals would pay higher taxes when they did not have children at home, but lower taxes while raising their kids. If birth rates rose to around 2.25, the payroll-tax increase could be eliminated. Families are helpful to Social Security’s financing, so Social Security should be friendly to families.

Finally, reformers should “experience rate” Social Security’s Disability Insurance payroll taxes. Over the past two decades, the share of working-age Americans collecting Social Security Disability Insurance (or SSDI) payments has doubled, from 2.3% to 4.6% of the population aged 25 to 64. Inflation-adjusted SSDI costs have roughly tripled over that time period, exceeding $125 billion in 2010, with an additional $70 billion in Medicare benefits offered to the disabled (since people who receive Social Security disability benefits are eligible for Medicare coverage, even though they are not yet 65). Unsurprisingly, the SSDI trust fund is projected to become insolvent in 2016.

Disability-insurance caseloads have not risen because more people have disabilities—in fact, the share of working-age individuals reporting a work-limiting disability has remained stable over the past three decades, according to Census Bureau data. But the percentage of individuals reporting disabilities who are employed has dropped by half since 1989. The main culprits are looser SSDI eligibility standards imposed by Congress in the 1980s, particularly with regard to often subjective ailments such as back pain and depression.

A way to reverse this trend would be to “experience rate” the employer’s share of Social Security disability taxes. Such a policy would reduce the tax rate when an employer’s disabled workers used rehabilitation, retraining, and other accommodations to stay on the job. At the same time, it would charge higher rates to businesses that sent many employees onto the SSDI rolls. The use of such experience rating in the Workers Compensation system has significantly reduced both the incidence and length of work-related disabilities. And this approach has shown similar results abroad: Because of experience rating, annual inflows into the Dutch disability program are 15% lower than they would be otherwise.

A similar 15% reduction in the disability-incidence rate would reduce Social Security’s total 75-year funding shortfall by roughly 11%; it would also yield significant savings for the Medicare program. And the improvements to Social Security financing could well be outweighed
by the long-term benefits to the disabled workers, who would have greater opportunities to stay on the job and secure a far better future for themselves and their families than a life built on government disability payments could possibly provide.

**True Social Security**

A set of reforms along these lines would allow Social Security to remain solvent and sustainable over the long term, funding itself without imposing a larger burden on the federal budget or taxpayers. By reducing disincentives to work, save, and delay retirement, these reforms would also bolster the larger economy.

These reforms would target benefits more accurately, so that poor retirees would not be allowed to fall through the cracks and the oldest retirees would receive resources when they needed them the most. And these reforms would endeavor to treat Social Security participants fairly, so that individuals and households with the same earnings and contributions would receive the same benefits, and so that parents who contribute to Social Security by raising future workers would receive some financial recognition and support.

Finally, these reforms build on a vision—and so could be supported by arguments—that ordinary Americans can understand. Instead of the minutiae of highly technical indexing formulas, these reforms can be expressed in terms that are comprehensible and meaningful. Americans won’t retire into poverty, but they will have to save. They won’t be penalized for working more. And while Social Security will be more affordable in the future, it will be a social-insurance program that truly works. Unlike the current system, a reformed Social Security will be there—solvent and sustainable—when Americans need it the most.