

# POLICYNOTE

## EXPANDING SOCIAL SECURITY BENEFITS ALL WORKERS

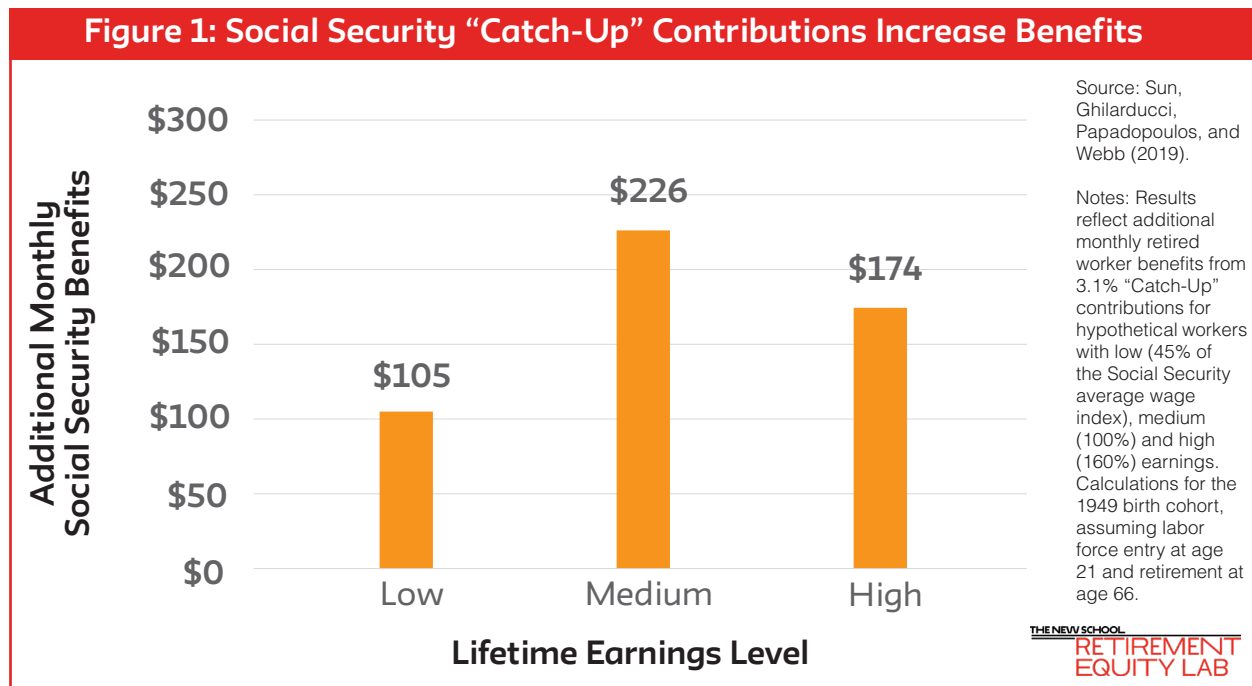
by **Siavash Radpour**, ReLab Research Associate; **Teresa Ghilarducci**, Bernard L. and Irene Schwartz Professor of Economics at The New School for Social Research and Director of SCEPA's Retirement Equity Lab (ReLab); and **Anthony Webb**, ReLab Research Director.

### ELEVATOR PITCH

Social Security provides insurance against the risk of outliving one's wealth that is valuable to low and high earners alike. Both low and high earners would benefit from Social Security expansion. We propose expanding Social Security by allowing workers to buy extra Social Security benefits. We propose defaulting workers into revenue neutral "Catch-Up" contributions. Starting at age 50, workers would contribute an additional 3.1% of salary. The typical worker would receive additional benefits of \$226 a month at retirement.

### KEY FINDINGS

- Social Security is more than a financial investment. It also provides insurance against the risk of outliving one's wealth, insurance that is valuable to low and high earners alike.
- Although higher earners receive lower financial returns on their Social Security contributions, both low and high earners would benefit from Social Security expansion through revenue neutral "Catch-Up" contributions of 3.1% of earnings starting at age 50.
- If "Catch-Up" contributions had been introduced 16 years ago, the typical worker retiring now would have received an additional \$226 a month in benefits, helping bridge the gap between retirement needs and resources.



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## EXPANDING SOCIAL SECURITY BENEFITS

Social Security is progressive, meaning higher earners receive lower returns on their contributions than lower earners. It is also efficient, transparent, well-governed and universal. Expanding Social Security is often portrayed as benefiting low earners at the expense of high earners due to the progressivity of the program. Additionally, the focus on rates of return neglects Social Security's provision of lifetime income, which provides valuable and cost-efficient insurance against outliving one's wealth. When lifetime income is considered, low,

middle, and high earners benefit from Social Security expansion.

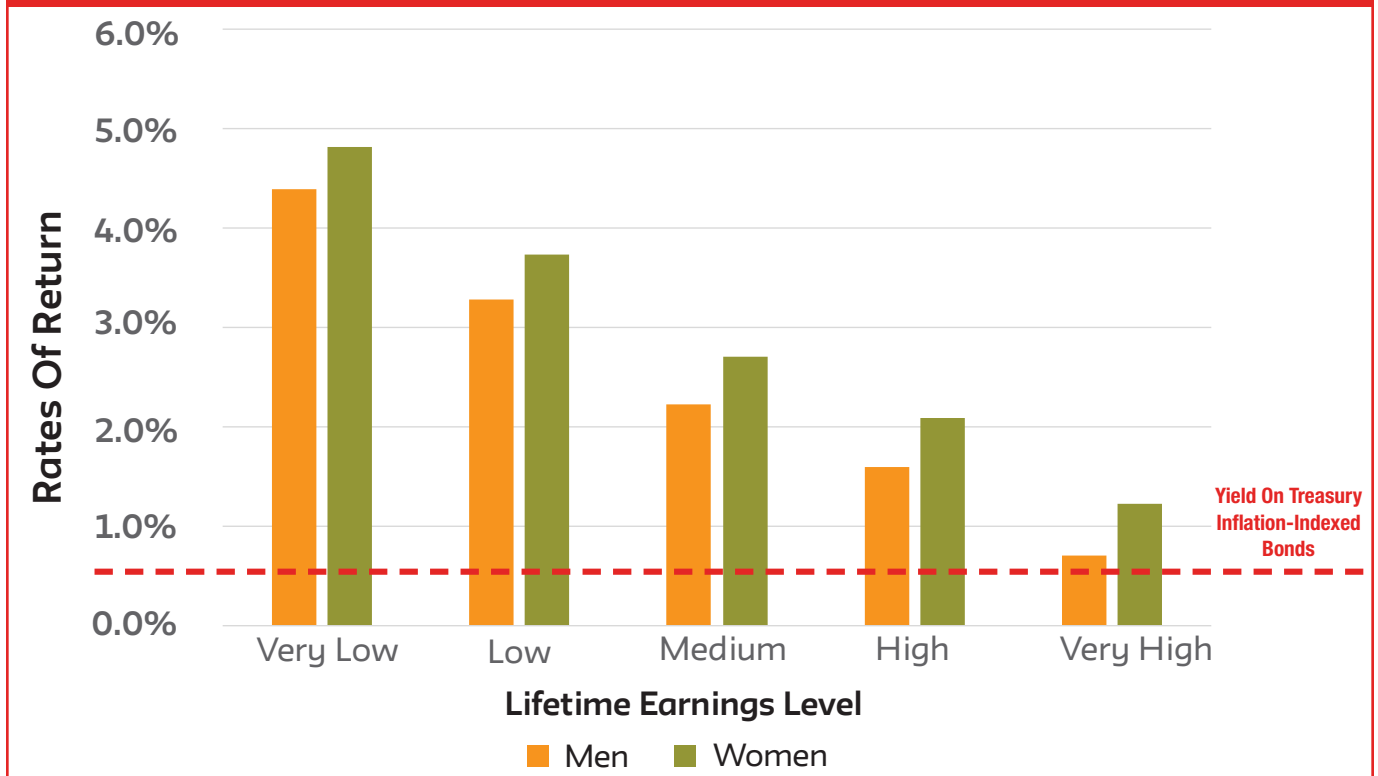
We propose mandating or defaulting all workers into Social Security "Catch-Up" contributions of 3.1 percent of salary, starting at age 50 (although it can be modified to start at younger ages). "Catch-Up" contributions would increase typical benefits by \$226 a month, which is not enough to solve the retirement savings crisis, but enough to shrink the gap between needs and resources.

## SOCIAL SECURITY PROVIDES HIGHER RETURNS TO LOWER EARNERS

By design, all workers contribute the same percent of earnings to Social Security, but Social Security provides higher replacement rates (benefits as a percent of pre-retirement earnings)

to low earners. As a result, lower earners receive greater rates of return than higher earners on regular and "Catch-Up" contributions. (Figure 2).

Figure 2: Rates Of Return From "Catch-Up" Contributions



Source: Clingman, Burkhalter, and Chaplain (2019).

Notes: Results reflect rates for return on 3.1% "Catch-Up" contributions for hypothetical workers with very low (25% of the Social Security average wage index), low (45%), medium (100%), high (160%) and maximum (Social Security taxable maximum in each year) earnings. Calculations for the 1955 birth cohort, assuming labor force entry at age 21 and retirement at age 65.

The return a medium earner can expect to earn on their Social Security contributions compares favorably with the 0.5 percent or so real return on 30-year Treasury Inflation-Indexed Bonds. Workers can, of course, expect higher returns in the stock market, but few would want to invest all their wealth in risky stocks.

Workers born after 1955 will earn lower rates of return because of the gradual increase in the Full Retirement Age to age 67. The increase in the Full Retirement Age is a benefit cut and the reduction in benefits exceeds the positive effects of people living longer.

## **SOCIAL SECURITY INSURES AGAINST OUTLIVING ONE'S WEALTH**

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Rate of return calculations understate the value of Social Security to workers at all earnings levels. Social Security provides benefits in the form of an annuity, a lifetime, inflation-adjusted income, that provides insurance against outliving one's wealth.<sup>1</sup> Although workers can purchase inflation-indexed annuities from insurance companies, these annuities are expensive due to adverse selection experienced by insurance companies (only healthy retirees buy annuities, and insurance companies set their prices

accordingly). In contrast, Social Security does not suffer from adverse selection because everyone, regardless of health, is automatically included in the risk pool. Workers can and do save for retirement by buying stocks and bonds, in taxable accounts or through IRAs and 401(k)s. But households face financial market risk, and using financial wealth to finance spending at advanced ages is more expensive than having Social Security do the job.

## **ALL EARNERS WOULD BE BETTER OFF WITH MORE SOCIAL SECURITY INSURANCE**

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Low and medium earners get a double benefit from Social Security expansion, a healthy rate of return coupled with a lifetime income. High earners earn a low rate of return on contributions

but this is more than offset by the value of the Social Security annuity. Both low and high earners would be better off if they were able to purchase even larger benefits.

## **HOW CATCH-UP CONTRIBUTIONS WORK**

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SCEPA proposes a program that would build on the existing structure of Social Security. Starting at age 50, workers would contribute an additional 3.1 percent of earnings (50 percent of existing contributions). Younger workers are often liquidity constrained – they often have student loans to repay, are starting a family, or are saving for a deposit on a house. That's why we propose additional contributions at age 50.

Employer contributions would not be increased. For years in which the worker contributed, the worker's earnings record would be credited with a 50 percent bonus, and benefits would be calculated on earnings inclusive of the bonus. Thus, a worker making \$50,000 would be credited with earnings of \$75,000, and a worker making \$200,000 would be credited with earnings of \$206,550 (1.5 times the 2020 taxable maximum of \$137,700). Independent analysis shows that the program would slightly reduce the Social Security actuarial shortfall.<sup>3</sup>

## MOST PEOPLE BENEFIT FROM CONTRIBUTING EVEN MORE TO SOCIAL SECURITY

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SCEPA calculated the amounts single individuals and married couple households should contribute to maximize their financial well-being. We assume they want to maximize consumption both before and after retirement, but are also averse to the risk of experiencing low consumption should they live unusually long. As with all calculations of this type, the results are sensitive to the assumptions made regarding the rate of return on financial assets, the extent to which households are willing to sacrifice consumption now in return for consumption in the future, and how much they fear the risk of very low consumption should they live unusually long. Importantly, households that have already accumulated 401(k) and IRA wealth

have the ability to use that wealth to help finance “Catch-Up” contributions - in essence, to use their financial wealth to purchase more of Social Security’s valuable annuity.

Plausible assumptions show that “Catch-Up” participation is advantageous for high and low earners alike. For our preferred assumptions, which lie in the economic mainstream, the ideal contribution rate is well above 3.1 percent (Figure 2). We feel confident that a 3.1 percent contribution rate would disadvantage few if any households, while conferring substantial benefits to many.

## POLICY RECOMMENDATIONS

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The AARP Policy Innovation Challenge competition chose Social Security “Catch-Up” contributions as a worthy innovation.<sup>2</sup> The program is almost exactly actuarially neutral – over a 75-year time horizon, contributions slightly exceed benefits.

A potential concern with a default is that those in need of additional retirement income might be less likely to participate. A mandate, however, would achieve universal coverage for a program that offers benefits to workers at all earnings levels, and would be within the social insurance tradition.

A contribution rate of 3.1 percent falls short of the amounts we calculate would maximize financial well-being, reflecting our concern that higher contribution rates might be unaffordable for some. Policy makers should consider allowing workers to contribute at a higher rate. Another potential concern is that higher earners might be more likely than lower earners to make additional contributions, exposing Social Security to adverse selection by reason of high earners’ lower mortality. But any difference in mortality would be offset by the lower rates of return earned by higher earners by virtue of the progressivity of the Social Security benefit formula.

## ENDNOTES

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<sup>1</sup> Social Security also provides spousal and child benefits and survivor benefits to a spouse, child, or dependent parent of a deceased worker that are also valuable.

<sup>2</sup> AARP (2018). AARP 2017 Social Security Policy Innovation Challenge - Awardees.

<sup>3</sup> Ghilarducci, T., Papadopoulos, M., Sun, W., & Webb, A. 2018. “Catch-up contributions: An equitable and affordable solution to the retirement savings crisis.” *Public Policy & Aging Report*, 28(S1), S4-S14.

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## APPENDIX: FIGURING OUT THE OPTIMAL SOCIAL SECURITY CONTRIBUTION RATE

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We model the consumption and savings decision faced by single individuals and married couples. Earnings increase with age and then decline as the household nears retirement. After retirement, the household receives Social Security benefits based on their pre-retirement earnings. The household faces mortality risk based on Social Security life tables. Each year, the household decides how much to save in financial assets. At age 50, the household decides whether it wants to make additional Social Security contributions in return for additional benefits. For example, if

a household making \$50,000 at age 50 chose to pay 50 percent in additional contributions - or 9.45 percent rather than 6.3 percent of earnings - it would be credited with \$75,000 rather than \$50,000 in its earnings record that year, with benefits being calculated accordingly. We calculate the contribution rate that maximizes the household's financial well-being, assuming the household wants to smooth the marginal utility of consumption over its lifetime.

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