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Social Adequacy and Individual Equity in Social Security

Most observers readily acknowledge that from its very inception our Social Security system has maintained a balance between social adequacy and individual equity. In its broadest sense, social adequacy means ensuring that all covered workers and their families enjoy adequate basic protection from a number of financial hazards. These include the problems that can occur when the worker dies, becomes disabled, or simply grows old. In its broadest sense, individual equity means ensuring that each covered worker will receive benefits commensurate with his or her history of contributions.

The question of whether the system has the right balance between social adequacy and individual equity has been the subject of constant debate. Many observers feel the balance is about right. Nevertheless, it is reasonable to expect that disagreement on the subject will be ongoing.

With the advent of proposals to replace the current system, at least partly, with a system of individual investment accounts, the question of social adequacy and individual equity assumes new significance. Individual investment accounts, by their nature, stress individual equity. Indeed, in their simplest form, these accounts place their emphasis entirely on individual equity. The requirement of social adequacy is satisfied, if at all, only to the extent that it is compatible with complete individual equity.

So, in considering individual account proposals, we must continue to debate the question of the right balance. And, to the extent the scales are not to be tipped entirely in favor of individual equity, we must determine how to maintain social adequacy in the world of individual accounts.

This issue brief examines the provisions of the current program that establish the balance between social adequacy and individual equity and explores devices that may be available under individual account arrangements to maintain all or any desired part of the current balance.

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Background

Investment is generally defined as putting money to use with an expectation of income or profit in return. In the Social Security context, the term individual equity has traditionally been used to describe the investment aspects of the program. If individual equity had been established as the sole objective of the program, benefit levels would have been formulated to directly relate to contribution levels. For example, a retiring worker with twice the accumulated contribution amount of another worker in otherwise identical circumstances would receive twice the old-age benefit.

In the Social Security context, the term social adequacy has traditionally been used to describe the welfare and insurance aspects of the program. If social adequacy were the sole objective, benefits might have been set at the same level for all workers, regardless of earnings and contribution levels, or might have been lower (or zero) for higher earners, or for those who had saved more for retirement, because they have lesser need.

Social Security was designed to contain elements of both individual equity and social adequacy. Social Security retirement benefits are higher for workers with a history of higher pre-retirement salaries (individual equity), but they provide a proportionately greater benefit for lower-income workers to help mitigate indigence among the elderly (social adequacy). The balance between these two elements has been maintained to varying degrees over the past 60 years.

The Current System

The current system serves the demands of individual equity in two important ways:

- Entitlement to benefits is based on a worker's age and employment history, and on the occurrence of events such as death, disability, and retirement. Benefits are paid without regard to need.
- The benefit formula provides higher benefits to workers with higher earnings or longer working careers, even though these workers are more likely to have pension and insurance coverage from their employers and may be more able to save for retirement on their own.

The current system serves the demands of social adequacy in the following ways:

First, the amount of the basic "pension" (called the primary insurance amount, or PIA) is aggressively skewed to favor lower-paid employees. A worker's PIA is determined by his or her average indexed monthly earnings (AIME), which reflects the worker's lifetime earnings relative to the earnings of all covered workers. For workers reaching age 62 in 2004, the formula is as follows:

90% of AIME up to $612, plus
32% of AIME from $612 up to $3,689, plus
15% of AIME exceeding $3,689.

The percentages remain the same from year to year, but the "bend points" ($612 and $3,689) increase each year, based on increases in the average wage.

Another way of looking at this is to compare replacement percentages; that is, the initial Social Security retirement benefit for an unmarried worker, assuming commencement at Social Security retirement age, expressed as a percentage of career average wage. The following table makes that comparison for workers with four hypothetical wage histories:

Average Wage Level	Replacement Percentage
Low (about 45% of each year's national average wage*)	56%
Medium (about 100% of each year's national average*)	42%
High (about 160% of each year's national average*)	35%
Maximum (the maximum Social Security taxable wage)	30%

*The estimated national average wage in 2004 (using intermediate assumptions) is about $35,000.

In addition to favoring lower-paid workers, the system favors less healthy workers and workers with dependent spouses and children:

- The worker's spouse receives 50 percent of the worker's benefit while the worker is alive, and, generally, 100 percent after the worker's death (provided the spouse is not entitled to a higher benefit based on his or her own earnings history). Benefits payable to spouses extend to divorced spouses to whom the worker was married for at least 10 years. These benefits are paid without any reduction in benefits to the worker or to other family members.
- If a worker is unable to work due to disability, Social Security pays disability benefits to the worker and family members.
- If a worker dies before becoming eligible for retirement, Social Security pays survivor benefits to the worker's spouse and other family members.

Analysis of the Current System

Pure individual equity and pure social adequacy represent the two poles on a continuum of possible program designs. At the individual equity pole, the benefits payable to each participant and dependents are based only on that participant's contributions and the contributions' investment earnings. At the social adequacy pole, the benefits payable to each participant and dependent are based only on need and bear no relation to contributions.

Between these poles, it is possible to protect workers from risks without using the contributions of some workers to subsidize the benefits of others. Such an arrangement would resemble commercially available insurance, in which similarly situated purchasers pay the same premiums but may receive widely varying benefits, depending on if and when the insured contingency occurs. However, some forms of protection, such as an adequate retirement income for low-wage workers, cannot be achieved without some degree of subsidy from higher-wage workers. This type of arrangement is sometimes called *social insurance* because, while it has some of the trappings of commercial insurance, it fulfills social goals that cannot be achieved without some classes of insureds subsidizing the benefits of other classes.

In general, where a particular arrangement falls on the continuum depends on the degree of risk pooling among workers — from no pooling at all, on one end of the scale, through subgroups of increasing size to the entire population at the other end. Under the current Social Security program, coverage is mandatory for most workers, and all covered workers contribute at the same rate, regardless of any attributes or circumstances that may affect the cost of providing their benefits. Because of the resulting subsidies among subgroups of covered workers, Social Security is considered a social insurance program.

Disability coverage and death benefit coverage under the current system illustrate this concept:

- Death and disability benefits are available on the same basis to all workers — risk is pooled for the entire working population, not for any subgroups.
- These benefits, as percentages of average wages, are more generous for lower-paid workers than for their higher-paid counterparts.
- These benefits are more generous for workers with family obligations than for single individuals.

In contrast, a worker seeking a commercial insurance policy covering death or disability would ordinarily be placed in a class of individuals with the same health, gender, age, and occupational status. Premiums for the class would be determined independently of premiums for workers in other classes.

The absence of classification creates some inequities in retirement benefits as well:

- The value of an income payable for life is much less for a single worker retiring with a known life-threatening medical condition than for a healthy counterpart. Nevertheless, the Social Security benefit is paid as a lifetime annuity determined on the same basis as for the healthy worker. Under a system more inclined toward individual equity, the unhealthy worker might be entitled either to a lump sum settlement or to an annuity considerably higher than the one available to the healthy counterpart.
- Individual equity considerations might suggest that a worker belonging to an ethnic class with a statistically demonstrable shorter-than-average life expectancy be entitled either to a lump sum settlement or to an increased annuity.
- Individual equity would suggest that the annuity for a female worker, given her longer average life expectancy, be less than for her male counterpart. (Of course, advocates of social adequacy are quick to point out that women historically have received lower wages for comparable work and have historically spent more time in non-wage roles as homemakers.)

To summarize, the current system includes aspects of individual equity and aspects of social adequacy. The structure of the current system hides, to some extent, a pattern of subsidies built into its social adequacy features.

Systems Using Individual Accounts Exclusively

Many observers view the current system as a carefully designed balance between individual equity and social adequacy. These observers, some of whom lean toward individual account proposals, believe this balance should be carried over into any individual account arrangement. The difficulty is that, under a pure individual account arrangement, any subsidies must be made explicit.

Individual Accounts With No Subsidies

A program that uses individual accounts exclusively offers no impediment to the incorporation of social adequacy considerations that do not involve subsidies. For this purpose, we are presuming a mandatory program financed by contributions that are a uniform percentage of pay for all participants. The contributions to a worker's account would simply be allocated to purchase coverage for the risks deemed sufficiently widespread, far-reaching, and social in scope and complexion to warrant coverage under the program.

- The amount of the contribution allocated for survivor protection would depend on the worker's age, sex, and health status, and on the amount of insurance deemed necessary, based on income and the number and ages of the worker's dependents.
- The amount of the contribution allocated for disability insurance would also be based on each worker's individual circumstances.
- Accumulated contributions at retirement, after deducting the cost of pre-retirement coverages, would be used to provide an assured income for the remaining lifetimes of both the worker and the spouse.

Workers' costs for all of these forms of protection would have one thing in common. Viewing all workers with the same age, sex, and health characteristics as a single class, the cost for workers in the class would be just enough to provide their benefits — no more and no less.

One issue that must be addressed is whether survivor protection, disability insurance, and annuitization at retirement should be mandatory or voluntary. If they were voluntary, measures would be necessary to protect the system against "selection." Selection would occur, for example, when workers who discovered they had serious illnesses rushed to establish survivor and disability protection where none had previously been selected.

Individual Accounts With Subsidies

If individual accounts are used exclusively, subsidies could be introduced in the following ways:

- The amount of the contribution allocated for survivor protection could be lower, relative to the amount of coverage, for lower-paid workers. Higher-paid workers would be subsidizing lower-paid ones.
- Alternatively, or in addition, survivor protection could be provided without having the worker's cost related to the age, sex, and health of the worker or even to the amount of protection purchased. Respecting each of these factors, workers in the less costly class would be subsidizing those in the more costly class.
- Disability insurance could be provided using the same techniques described above for survivor protection.
- Retirement annuities could be provided using contribution rates that would be more attractive for lower-paid workers. Mechanically, this would probably require that each year a worker's contributions be allocated to two accounts. Account A would receive contributions up to a certain dollar level, and Account B would receive any contributions above this level. At retirement, Account A would be annuitized using a more attractive annuity rate than the one available to Account B. As with death and disability insurance, higher-paid workers would be subsidizing lower-paid ones.
- Married participants could receive annuities with extended benefits for surviving spouses, using the same annuity rates as those for single workers with straight life annuities. Single workers would be subsidizing married ones. And, as has often been pointed out, two-paycheck couples would be subsidizing those with just one wage earner.
- Above-market investment return rates could be credited to the accounts of lower-paid workers. The mechanics might be analogous to the dual annuity rate arrangement described above. Account A would receive contributions up to a certain dollar level, and Account B would receive any contributions above this level. Account A would receive higher investment credits, with

credits to Account B depressed to the degree necessary to finance the Account A subsidies. A portion of the investment return of higher-paid workers' accounts would thus be used to finance a subsidy for the lower-paid workers.

Participation in any of these arrangements would need to be mandatory. Under any voluntary arrangement, higher-paid workers could reasonably be expected to opt out.

One problem with any of these devices is that "money's worth" complaints, so prominent in fueling individual account proposals, would not be silenced. Higher-paid workers could be expected to complain that they were not getting their money's worth. In addition, some planners would react negatively to the inherent redistribution of income and wealth embedded in these devices. It is worthwhile to remember that the existing system involves the same elements of redistribution, although in a less obvious way.

Hybrids of the Current System With Individual Accounts

Some proposals have been structured to include individual accounts and a scaled-down base plan. This base plan is similar to the existing program — only smaller. With these two-plan arrangements, introducing subsidies becomes much easier. The approaches already mentioned for a program offering individual accounts exclusively would all still be available. However, three simpler options would become available, as follows:

- Benefits under the base plan could be oriented toward social adequacy to a much greater degree than under the current program. The rationale would be that the individual account arrangement has swung away from social adequacy and toward individual equity; thus, it is appropriate for the base plan to make an offsetting swing in the other direction. In the extreme, benefits under the basic plan could be unrelated to employment history. They would simply be the same amount for all workers no matter how long they worked and how much they earned.
- Survivor protection and disability insurance could be provided under a program resembling the current system, while retirement benefits could be provided, in whole or in part, by individual accounts.
- As an alternative, the allocation of contributions might be shifted further in the direction of social adequacy than at present. For example, suppose the combined total employer-employee Social Security contribution remained unchanged at 12.4 percent. This total might be allocated thus:

Portion of Taxable Annual Wage	Allocated to Individual Account	Used to Finance Base Plan
The first $10,000	6%	6.4%
$10,000 to $40,000	4%	8.4%
Over $40,000	2%	10.4%

Under this arrangement, base plan coverage would constitute a better deal for lower-paid workers. Lower-paid workers would see their accounts grow, in percentage terms, faster than the accounts of their higher-paid counterparts.

As with the possible approaches to individual accounts only, neither of these arrangements involving the base plan would lay the money's worth objection to rest. Suppose, for example, the base plan were a flat benefit, regardless of compensation history. The higher-paid worker would not be pleased by a pay-related contribution for a non-pay-related benefit, although Medicare Parts A and B provide precedents.

Conclusion

In considering any individual account proposal, it is important that policymakers and planners understand its impact on the balance between social adequacy and individual equity. To the extent it is intended that this balance be changed, that intent should be candidly discussed. To the extent it is represented that the balance will remain unchanged, there should be a clear understanding of the steps being proposed to maintain this balance and a demonstration that the proposed steps will accomplish their objective.

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