View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by DigitalCommons@Kennesaw State University

Kennesaw State University
DigitalCommons@Kennesaw State University

Faculty Publications

6-2005

Farmers and Social Security Reform

James L. Novak
Auburn University Main Campus

Paul Gentle
Renmin University of China

Patricia Duffy
Auburn University Main Campus

Alison Keefe
Kennesaw State University, akeefe@kennesaw.edu

Follow this and additional works at: http://digitalcommons.kennesaw.edu/facpubs

Part of the Agricultural and Resource Economics Commons

Recommended Citation

Novak, J. L., Gentle, P., Duffy, P., & Keefe, A. (2005). Farmers and social security reform. Choices: The Magazine of Food, Farm & Resource Issues, 20(2), 157-160.

This Article is brought to you for free and open access by DigitalCommons@Kennesaw State University. It has been accepted for inclusion in Faculty Publications by an authorized administrator of DigitalCommons@Kennesaw State University. For more information, please contact digitalcommons@kennesaw.edu.

CHOICES
The magazine of food, farm, and resource issues
2nd Quarter 2005 • 20(2)
A publication of the American Agricultural Economics Association

Farmers and Social Security Reform

By James L. Novak, Paul Gentle, Patricia Duffy, and Alison Keefe

For several years, reports from the Trustees of the Social Security system have warned us that at the current rate of benefits and given the current age structure of our population, the Social Security system will go broke sometime between 2038 and 2042. To address Social Security Trustees' concerns, President Bush, in his postelection speech, reported that one of the legacies of his administration would be to reform the Social Security system. Farm operators tend to be older, on average, than people in other populations, meaning that changes in Social Security would more likely be of near-term concern to them. Although there is still considerable debate on whether reform is necessary or desirable, this article reports on what a changed Social Security system might look like, and how changes in the system might affect farmers' need for additional savings.

Social Security Today

Trustees of the Social Security system are appointed to oversee the four separate funds that make up the current Social Security Trust Fund Account. These funds are *Social Security* (Old Age and Survivors Insurance, OASI), *Disability Insurance* (DI), Medicare's *Hospital Insurance* (HI), and *Supplementary Medical Insurance* (SMI). OASI is what most people consider when they talk about Social Security retirement income.

Social Security is a pay-as-you-go system (sometimes called "pay-go"). It was designed so that current workers pay for the benefits of current retirees out of taxes. Payroll and self-employment taxes, premiums, and other income are deposited to trust fund accounts. Retirement and disability benefits and administrative costs are paid from the OASI and DI funds. Trust funds not used in the current year are invested in government bonds. When the bonds reach maturity or are needed, they are cashed to pay benefits. According to the Social Security Administration, the nominal interest rate earned on OASI and DI funds in 2004 was 4.3% (OASDI Trustees, 2005).

Proposals for Reform

Many proposals for fixing the Social Security system have been drafted over the past years. These can be summarized as follows:

- keep the current system (OASDI) intact and maintain or raise existing benefits;
- keep the current system intact but reduce benefits;
- change to a regulated two-tiered retirement system, which includes reducing current OASI benefits and making up the difference with a Personal Savings Account (PSA);
- develop a regulated PSA system, eliminate SS benefits entirely, and provide a PSA invested in securities but regulated by the government; or
- eliminate the Social Security system and allow the private sector to handle retirement.

In 2001, the final report of the President's Commission to Strengthen Social Security (2001) listed three voluntary proposals for reforming the Social Security system. The President's recent proposal for reform comes largely from this Commission's study. The idea behind all three proposals is that Social Security benefits would be lowered but made up for ("offset") using a worker's own *Personal Savings Account* (PSA). PSA funds are to be invested and are to earn an interest rate guaranteed to exceed inflation. A retirement annuity would be paid from these funds based on the individual's life expectancy and contributions to his or her own PSA. Benefits from individual savings are projected by the 2001 Commission to be higher or to at least equal to those received under the current Social Security system.

Under the Commission's first proposal, a *Two Percent Personal Account* would result in expected benefits that would exceed (by approximately 12%) those received under the current (2001) Social Security system. This proposal establishes a PSA with voluntary contributions of 2% of taxable wages. Invested funds would be com-

©1999–2005 CHOICES. All rights reserved. Articles may be reproduced or electronically distributed as long as attribution to *Choices* and the American Agricultural Economics Association is maintained. *Choices* subscriptions are free and can be obtained through http://www.choicesmagazine.org.

pounded at a guaranteed rate of 3.5% above inflation.

The Commission's second proposal is called the *Voluntary Progressive Personal Account*. This proposal establishes voluntary personal accounts without raising taxes or requiring worker contributions above what is currently required. Features of this program include:

- voluntary contributions of 4% of "redirected payroll taxes" from the OASI trust fund to a PSA, with PSA contribution limits of $1,000 annually;
- contributions are to compound earnings at an interest rate of 2% above inflation;
- the $1,000 contribution limit would be adjusted upward for annual inflation; and
- OASI benefits would be indexed to price inflation rather than national wage growth.

Social Security benefits payments will be offset by payments from the workers' individual personal accounts. According to the Presidential Commission, total benefits are expected to at least equal the OASI benefits received (as measured by 2001 income). Under this plan, additional Social Security benefits would be paid to low-pay, high-risk workers. The minimum Social Security benefit payable to 30-year minimum wage earners would be at a rate of 120% of the poverty level.

The third proposal deals with *Voluntary Add-On Accounts with Matches from Payroll Taxes*. This proposal "carves out" a part of the payroll tax and invests that amount in PSAs. This proposal is designed to preserve Social Security benefits (as calculated in 2001) by allowing workers to contribute voluntarily an additional 1% of wages to a PSA. Features of this proposal are:

- The 1% would be matched by 2.5% of a worker's payroll taxes up to a maximum of $1,000 annually;
- contributions would be compounded at 2.5% above inflation, with the maximum contribution indexed by inflation; and
- refundable tax credits would be given for the add-on contribution.

Under this plan, scheduled Social Security benefits would be offset by payments from workers' personal accounts. Minimum benefit of 100% of poverty level would be guaranteed for 30-year workers and 111% of the poverty level would be guaranteed for 40-year workers. Any benefits received from the Social Security system would be modified by adjusting the growth rate for future changes in life expectancy, decreasing early retirement benefits, increasing benefits for delayed retirement, and reducing the benefits for those with higher incomes.

So What's the Downside?

If all of this sounds good, what's the downside? Concern has been expressed about the cost of implementing the personal savings account system. The cost of funding and regulating such a system, independent of the contributions required by the workers, has been estimated by at least one source to be an additional $25–50 per person per year, on top of what the current system costs, which is about $16 per person per year (Hill, 2000). A Congressional Budget Office report (Walliser & Becker, 1999) estimates PSA administrative costs (based on Chilean and Argentinean PSA experience) at about $50 per contributing worker per year—similar to the cost experienced by US employer-sponsored pension plans.

Legislated minimum guarantees may be of particular value in the case of limited-resource farmers or for farmers with financial difficulties. A potential PSA fund accumulation problem for farmers in particular is that they may have years of minimum or no contributions because of farm operating losses. Farm profits contribute to the size of fund an individual can accumulate. The longer contributions are in a fund, the more time they can compound and potentially accumulate into a larger nest egg on which to draw during the retirement years.

Issues such as the definition of emergencies (natural disasters, health emergencies, etc.), which would allow for early withdrawal, would need to be worked out. Other questions include: If participants outlive their PSAs, should the system continue paying benefits? If individuals mismanage their portfolios, what should be done?

Investment Policy

An excellent article on the marginal effects of four proposals for restoring long-run actuarial solvency to the Social System looked at "including the establishment of private accounts, providing for Trust Fund investment in private securities, using General Fund revenues, and changing the benefit structure of Social Security" (Lyon & Stell, 2000, p. 473). Their finding is that a one-step process of contributing 2% of payroll taxes to a PSA (at the historic 3% rate of return earned on long-term bonds) would not fix the system. Additional measures, such as a transfer of funds from the General Fund or earning higher rates of return (6%), are required to balance the sys-

tem. Restoring solvency to the system as it currently exists requires such measures as including newly hired state and local workers in the system, raising the Normal Retirement Age, and increasing the contributions and benefits base to 90% of covered wages.

With regard to private investments, a portfolio of 40% bonds and 60% stocks has been suggested for Personal Savings Accounts (Liu, Rettenmaier, & Wang, 2001; Lyon & Stell, 2000). At least one opponent to stock market investment, John Mueller, expressed concern over its volatility (Mueller, 1997). Liu et al. (2001) point out that the higher interest rate earned in the market is largely a risk premium. The relative riskiness of alternative investments would certainly need careful weighing in any move to a PSA-type system.

Farmer Savings Needed to Replace Social Security?

Table 1 shows the accumulated savings needed to provide $775, $979, and $1,327 monthly annuities to replace average age 62, 65, and 70 Social Security benefits, respectively, for an individual born in 1936 and who earned the national average wage for the past 35 years. Although it is unlikely that there is a farmer who earned exactly the national average wage rate for the past 35 years, these numbers are provided to show the approximate retirement fund necessary to replace Social Security on average. For example, on average, a $152,000 nest egg would be required (at a 2.5% real rate of return on investment) to replace a $775 Social Security monthly annuity with a PSA annuity.

Seventy to eighty percent of pre-retirement earnings has been estimated to provide a retiree with his or her pre-retirement standard of living. Shipman states that to achieve a 70% income replacement at retirement, "one's portfolio would have to earn an annual real rate of return of 5.7%" (p. 1). Table 1 shows that a 6% return on investments would require retirement funds of $110,893 to pay $775 per month, $129,128 to pay $979 per month, and $143,502 to pay $1,327 per month. Additional family savings would be required to replace Social Security annuities for both a husband and wife. At Normal Retirement Age, spousal annuities are currently 50% of the primary earner's annuity. Family earnings are subject to maximum limits. Higher earnings on investment would reduce the size of the fund required for retirement.

Table 1. Savings required to provide a monthly annuity equal to average earned social security benefits ($).

Retirement age	Monthly annuity ($)	Investment portfolio rate of return				
		2.5%	3.5%	4.5%	5.5%	6%
62 (early retirement)	775	152,000	138,166	126,197	115,678	110,893
65 (normal retirement)	979	170,500	156,725	144,753	134,052	129,128
70 (delayed retirement)	1,327	176,583	166,125	156,510	147,661	143,502

Note. Assumes a person will live to age 83.

Care Needed In Redesigning the System

There is significant discussion about the cost of implementing a dual retirement system and whether any cost savings would result from such changes. Farmers who participate in the Social Security system would be subject to the same impact as the general population of self-employed if the benefits formula were changed. In 1998, 150,000 limited-resource farmers had household incomes of $9,924 and current assets of $6,790. This group of farmers is relatively poor (19.1% of national average income) and would expect a significant impact from Social Security changes. However, farmer retirees are not generally totally dependent on Social Security. According to a USDA Economic Research Service study of retired farmers, farm rental, value of farm products consumed, and CRP are listed as sources of retirement income (Hoppe, 1996). Total household income was listed as 88% of the national average income (Hoppe et al., 2001). Two problems identified by ERS with farm assets as a source of retirement funding is the relatively fixity of real estate assets and that partnership arrangements may complicate conversion of wealth to a liquid form (Hoppe et al., 2001).

Alternatives to reforming the Social System include raising payroll taxes, cutting benefits, and eliminating tax cuts. Although reform is mostly targeted to younger wage earners, changes to the tax system will affect nonretired as well as retired farmers.

According to the Trustees and others, if the system is to be "fixed," an early fix is preferred. According to the 2003 Trustees report, "To the extent that changes are delayed or phased in gradually, greater adjustments in scheduled benefits and revenues would be required" (Social Security and Medicare Boards of Trustees, 2003, p. 1).

Clearly, changes to the system should be designed with care and with adequate safeguards for farm as well as nonfarm participants. Potential savings problems of farmers and

other self-employed individuals, like accounting for low or negative income years, health problems, and accidents, should be factored into the reform equation. Anything less would result in more insecurity than the current debate provides over the future of Social Security.

For More Information

Hill, C. (2000). *Why privatizing social security would hurt women* (publication #D437RB). Washington, DC: Institute for Women's Policy Research. Available on the World Wide Web: http://www.iwpr.org/pdf/CATORIB.PDF.

Hoppe, R.A, Johnson, J., Perry, J.E., Korb, P., Sommer, J.E., Ryan, J.T., et al. (2001). *Structural and financial characteristics of U.S. farms: 2001 family farm reports* (Ag Information Bulletin 768). Washington, DC: United States Department of Agriculture Economic Research Service. Available on the World Wide Web: http://www.ers.usda.gov/publications/aib768/.

Hoppe, R. (1996). *Change in farm survey allows first in-depth look at farming retirees* (AER 730). Washington, DC: United States Department of Agriculture Economic Research Service.

Liu, L., Rettenmaier, A.J., & Wang, Z. (2001). *Social security and market risk* (policy report no. 244). Washington, DC: National Center for Policy Analysis.

Lyon, A.B., & Stell, J.L. (2000). Analysis of current social security reform proposals. *National Tax Journal*, *53*(3), 473-514.

Mueller, J. (1997). *Three new papers on "privatizing" social security, one conclusion: bad idea.* The National Press Club, October 14, 1997. New York: Global Action on Aging. Available on the World Wide Web: http://www.globalaging.org/pension/us/socialsec/mueller.htm.

OASDI Trustees. (2005). *2005 OASDI trustees report: Assumptions and methods underlying actuarial estimates: Economic assumptions and methods*. Washington DC: United States Social Security Administration. Available on the World Wide Web: http://www.ssa.gov/OACT/TR/TR05/tr05.pdf.

President's Commission to Strengthen Social Security. (2001). *Strengthening social security and creating personal wealth for all Americans*. Washington, DC: Author. Available on the World Wide Web: http://www.csss.gov/reports/Final_report.pdf.

Shipman, W.G. (2001). *Is the stock market too risky for retirement?* (brief analysis 382). Dallas: National Center for Policy Analysis. Available on the World Wide Web: http://www.ncpa.org/pub/ba/ba382/ba382.pdf.

Social Security and Medicare Boards of Trustees. (2003). *Status of the social security and medicare programs. A summary of the 2003 annual reports.* Washington, DC: United States Social Security Administration. Available on the World Wide Web: http://www.ssa.gov/history/pdf/tr03summary.pdf.

Walliser, J., & Becker, S.M. (1999). *Social security privatization: Experiences abroad*. Washington, DC: Congressional Budget Office. Available on the World Wide Web: http://www.cbo.gov/ftpdocs/10xx/doc1065/ssabroad.pdf.

James Novak is an extension economist and professor in the Department of Agricultural Economics and Rural Sociology at Auburn University. Paul Gentle is a visiting assistant professor at the School of Economics of Renmin University, China. Patricia A. Duffy is with the Department of Agricultural Economics and Rural Sociology at Auburn University. Allison Keefe is an assistant professor of economics in the Department of Leadership and Professional Development at Kennesaw State University.