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CATCH-UP CONTRIBUTIONS: AN EQUITABLE AND AFFORDABLE SOLUTION TO THE RETIREMENT

Executive Summary

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CATCH-UP CONTRIBUTIONS: AN EQUITABLE AND AFFORDABLE SOLUTION TO THE RETIREMENT SAVINGS CRISIS

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Social Security replacement rates are projected to fall in coming decades due to the increase in the full retirement age (which is equivalent to a 13.3 percent cut in benefits to a worker retiring at age 65), increasing Medicare Part B and D premiums, and increased taxation of benefits. The cut in benefits will impose hardship on low-wage workers, who are often ineligible to participate in employer-sponsored pension plans and have few financial assets. Workers in their 50s may be particularly hard hit, as they would often need to save implausibly large shares of their incomes to achieve replacement rates that would permit them to maintain their preretirement standard of living.

To address the needs of these two overlapping groups—low-wage workers and workers in their 50s with no or inadequate pension wealth—we propose a system of cost-neutral voluntary Social Security "catch-up" contributions starting at age 40 or 50 that would use the progressivity of the Social Security benefit formula to target low-wage workers.

Under current law, households are not permitted to purchase additional Social Security benefits. Policy analysts have proposed allowing households to purchase additional benefits at retirement, but these proposals have failed to gain traction because of concerns that (a) purchasing additional benefits would do nothing to help those most in need—that is, households with no annuitizable wealth—and (b) Social Security would suffer from adverse selection, with low-mortality households being disproportionately likely to participate.

We propose catch-up contributions of 1.86 percent of salary starting at age 40 or 3.1 percent of salary at age 50, comprising 30 percent and 50 percent of existing contributions, respectively. To avoid the possibility that the policy could increase age discrimination, the employer contribution would not be increased. Further, we included mechanisms to address characteristics specific to low-wage workers. Although 50 is an age at which an individual's awareness of retirement increases, low-wage workers often exit the labor market at relatively young ages and experience earnings declines in their 50s; thus, both scenarios could harm these workers' ability to capture the benefits of catch-up contributions. We therefore investigated whether allowing people to participate from age 40 might yield better outcomes for vulnerable populations.

Maximum earners would have enjoyed the largest increase in benefits, $345 a month, compared with $66 and $119 a month for very low and low earners, respectively.

Participants' earnings would be adjusted proportionately so that, in the age-50 scenario, a worker with earnings of $50,000 would be credited with a $25,000 supplement in his or her record of taxable earnings (50 percent of $50,000), and a worker with earnings of $200,000 would be credited with a supplement of $63,600 (50 percent of the 2017 taxable maximum of $127,200). Average indexed monthly earnings and primary insurance amount would be based on earnings inclusive of the supplement so that low earners would receive a higher return on their catch-up contributions.

We first report the impact for very low, low, medium, high, and maximum lifetime earners retiring in 2016, assuming that they had been eligible to participate throughout their careers. Maximum earners would have enjoyed the largest increase in benefits, $345 a month, compared with $66 and $119 a month for very low and low earners, respectively. But very low and low earners would have enjoyed larger increases in replacement rates, 7.2 percentage points each, compared with 3.8 percentage points for maximum earners. Thus, although the program would have significantly increased the Social Security replacement rates of low earners, the replacement rates remain short of the levels that would maintain their preretirement standard of living. Catch-up contributions are not a substitute for expansion and reform of employer-provided retirement plans.

Very low lifetime earners would have enjoyed the highest rate of return on catch-up contributions, 3.59 and 4.60 percent for men and women, respectively, compared with minus 0.23 percent and minus 0.94 percent, respectively, for maximum earners; however, rate-of-return calculations ignore the value of the longevity insurance provided by Social Security. Taking account of the value of longevity insurance, and assuming that workers were able to invest in a risk-free asset yielding a 3 percent real return, well above current rates, we calculate that maximum earning men and women would have been willing to pay as much as 4.60 and 4.85 percent of salary, respectively, for access to catch-up benefits, substantially more than the 3.1 percent contribution. Thus, the program is one that targets low-wage workers while remaining attractive to higher earners.

We use the Dynamic Simulation of Income Model, or DYNASIM, to project how the program affects succeeding birth cohorts, assuming introduction in 2017. Given that prototypical households have positive willingness to pay, we assume universal participation. The impact of catch-up contributions increases over time, but even by 2055, catch-up contributions starting at age 50 result in only a modest 1.9 percentage point decline in the share of individuals over 62 who are poor or near poor (defined as having per-capita incomes of less than 200 percent of the federal poverty level of $24,120 in 2017). This modest decline in poverty reflects the small impact of catch-up contributions on the Social Security benefits of the bottom quintile of households by shared lifetime earnings. Starting contributions at age 40 results in similar poverty reductions, although the phase-in period is longer.

Next, we use the DYNASIM model to project the impact of catch-up contributions on the solvency of the Social Security program. Over a 25-year horizon, the reform narrows the actuarial shortfall from 1.45 percent to 0.93 percent of payroll, reflecting additional payroll tax receipts that are not matched by additional benefit payments. The program postpones exhaustion of the Trust Fund from 2034 to 2037. Over a 75-year horizon, the reform is almost exactly actuarially neutral.

We evaluate the merits of a default versus a mandate. A default might be more politically acceptable because contributions might then be perceived not as a tax increase but as the purchase of valuable future benefits. A mandate, meanwhile, eliminates the risks of opt-outs by vulnerable groups and conversely of opt-outs by high earners that might adversely affect the sustainability of the program and precipitate a contribution death spiral. A mandate avoids both of these risks and would also be within the spirit of Social Security and other social insurance programs that use mandates to both broaden the risk pool and protect against adverse selection.