

# WORKING PAPER

## *Executive Summary*

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# FISCAL EFFECTS OF SOCIAL SECURITY REFORM IN THE UNITED STATES

BY COURTNEY COILE AND JONATHAN GRUBER

The Old-Age, Survivors, and Disability Insurance (OASDI) program faces a serious long-term solvency crisis. The 2001 Trustees' Report projects that the OASDI trust funds will be exhausted in 2038 and that an immediate and permanent tax increase of 1.86 percent of taxable payroll could be needed to restore solvency for the next 75 years. Over the past several years, many Social Security reforms have been suggested to address the solvency crisis, from further increases in the normal retirement age to partial privatization of the system.

Many of these proposals would improve the fiscal balances of the OASDI program by cutting benefits, raising taxes, or both. However, the fiscal implications of these reforms depend critically not just on the static impacts of the reforms on benefit payments and tax collections, but also on dynamic responses of individuals to changes in program incentives. In particular, there is a large literature over the past two decades which suggests that retirement decisions are responsive to the parameters of the Social Security system. If reform alters retirement patterns, this will in turn impact benefit payments and tax collections both inside and outside of the Social Security system. For example, if raising the early entitlement age for Social Security leads to later retirement, this may significantly improve the government's fiscal position above and beyond the savings from starting payments later in life.

While some previous studies of Social Security and retirement have forecast the effect of various reforms on labor supply, little of the work in the U.S. has focused on the impact of reforms on the fiscal position of the government. That is, there has been little attempt to date to marry dynamic models of retirement responsiveness to estimates of the impact of reform on fiscal balances.

We propose to incorporate labor supply responses into our simulations of the effect of Social Security reforms on older workers' net fiscal contributions to OASDI. Such reforms will have both an automatic effect on fiscal contributions by changing contributions and benefits for a given work history (the "mechanical" effect) and an additional effect through labor supply responses to the reform (the "behavioral" effect). We will estimate the fiscal implications of both the mechanical and the behavioral effect, using retirement models to predict labor supply responses. The result will be an estimate of the steady-state impact of the reforms on the financial balance sheet of the OASDI program. We will also include income and consumption taxes in our analysis in order to examine the effect of the reforms on total government finances.

To be clear, we are not engaging in a full blown solvency analysis along the lines of that carried out by the Social Security Administration (SSA). We do not consider the impact of reform on both transition and long run system finances. Rather, for illustrative purposes, we follow one cohort of workers, and illustrate the impacts of reforms on the benefits paid to, and the taxes collected from, this cohort. This gives some guide as to the percentage effects of reforms on system balances.

We have two key findings from this exercise. First, major reforms to the system can have substantial impacts on fiscal balances. Raising the early and normal retirement age by three years improves net fiscal balances by roughly one-third of baseline benefits. On the other hand, reducing the early retirement age to 60 and raising the replacement rate to 60% would lead to a deterioration of fiscal balances by over one-half of baseline benefits.

Second, behavioral responses to system reforms only contribute modestly to fiscal balance effects. This is because the Social Security system as a whole is roughly actuarially neutral. As a result, delaying retirement has little net impact on system finances. However, when other taxes are factored in, then delaying retirement does increase net government revenue. Thus, behavioral effects on the system as a whole are not zero, but they are dominated by the mechanical effects of reform.

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**CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE**

Fulton Hall 550, 140 Commonwealth Avenue, Chestnut Hill, MA 02467-3808  
phone 617.552.1762 fax 617.552.1750 [crr@bc.edu](mailto:crr@bc.edu) [www.bc.edu/crr](http://www.bc.edu/crr)