

Insider

Health and benefit implications of year-end spending laws

By Anu Gogna and Ben Lupin

On December 20, 2019, President Trump signed into law the **Further Consolidated Appropriations Act, 2020**, which includes significant changes for employer-provided retirement, health and other benefit programs. The following health and welfare benefit-related provisions have implications for employers:

- The Affordable Care Act's (ACA's) "Cadillac" tax and medical device tax were repealed as of January 1, 2020.
- The ACA's health insurance tax (HIT) will be repealed effective January 1, 2021.
- The fee to fund the Patient-Centered Outcomes Research Institute (PCORI) paid by group health plans and health insurance issuers is extended for 10 years (through 2029).
- A tax credit for employers that provide qualifying paid family and medical leave to certain employees is extended for one year (through 2020).

Key implications and suggestions for employers moving forward are outlined below.

General discussion and observations

ACA taxes repealed

Cadillac tax. The act fully repeals the Cadillac tax, which would have imposed a 40% excise tax when the value of a group health plan exceeded specified thresholds. Repeatedly delayed by Congress, the tax never took effect.

- *Employer implications.* Employer plan sponsors will need to review any potential plan design changes or future budgeting meant to avoid paying the tax in 2022. While employers may want to consider such changes for cost-saving purposes, no plan changes will be required to avoid paying the Cadillac tax.

In This Issue

- 1 Health and benefit implications of year-end spending laws
- 2 DOL finalizes regular rate of pay rule for overtime purposes
- 4 IRS issues Required Amendments List for 2019
- 5 Puerto Rico 2020 retirement plan limits
- 6 Social Security reform: A call for facts, transparency and fairness

News in Brief

- 5 Appeals court holds ACA individual mandate unconstitutional

Medical device tax. This 2.3% excise tax on sales of medical devices, such as pacemakers, is repealed. This tax initially went into effect in 2013 but was suspended by Congress from 2016 to 2020.

- *Employer implications.* As this tax was imposed on the medical device makers, it had the least direct impact on employer plan sponsors, although it likely resulted in increased product costs, which could have been indirectly passed onto employers. Plan sponsors should consider discussing with their carrier or third-party administrator any potential savings due to this tax being repealed.

Health insurance tax. The HIT, repealed for calendar years beginning after December 31, 2020, applies to all insurers that offer *fully insured* health insurance in the marketplaces, the group market or public programs (such as Medicare and Medicaid). This tax was in place from 2014 through 2016. Although Congress approved a one-year moratorium for 2017, the HIT went back into effect for 2018 before being suspended again for 2019. So, while the HIT is suspended for 2019, it will apply for 2020 and then will be repealed as of 2021.

- **Employer implications.** Repeal of the HIT will not take effect until 2021, meaning the tax, which has already been built into many fully insured health plan premiums for the 2020 plan year, will continue to be paid by employers as a pass-through from their fully insured carriers. Fully insured plan sponsors will need to make sure the HIT is removed from their 2021 plan renewal rates.

PCORI fee extended 10 years

The act extends the PCORI fee¹ until 2029. While originally scheduled to end in 2019 (for calendar-year health plans), this 10-year extension will continue to fund the PCORI Trust Fund.

- **Employer implications.** Once the IRS announces the adjusted dollar amount for 2020 PCORI fee filings, employer plan sponsors can budget for this fee in 2020 and beyond. The PCORI fee will continue to be paid by employers (for self-insured plans) or by the insurance carrier as a pass-through expense (for fully insured plans).

Tax credit extended one year for paid family and medical leave

The employer tax credit for paid family and medical leave, originally enacted as a two-year program (2018 and 2019), is extended through December 31, 2020. Under the Tax Cuts and Jobs Act of 2017, the tax code was amended to provide a tax credit for employers who provide paid family and medical

Fully insured plan sponsors will need to make sure the HIT is removed from their 2021 plan renewal rates.

leave to certain employees. Eligible employers may claim the credit, equal to a percentage of wages they pay to “qualifying employees” while those employees are on family and medical leave, restricted to a maximum annual leave period of 12 weeks.² The credit may now be claimed in the 2020 tax year.

- **Employer implications.** Employers with leave programs in place that met the eligibility requirements for the tax credit may earn the credit for 2020. Employers who did not adopt such a program (or did not previously amend their existing program to meet the tax code requirements) might have missed the deadline to make the required changes to claim the credit for 2020. Employers should evaluate their leave programs in light of this extension. The IRS will need to provide guidance on timing for adopting or amending programs to claim the tax credit in 2020.

For comments or questions, contact Anu Gogna at +1 973 290 2599, anu.gogna@willistowerswatson.com; or Ben Lupin at +1 215 316 8311, benjamin.lupin@willistowerswatson.com.

¹ For more information on the PCORI fee, see “PCORI fee due by July 31, 2019,” *Insider*, May 2019.

² For more information on the tax credit for paid family and medical leave, see “IRS issues guidance on tax credit for paid family and medical leave,” *Insider*, October 2018.

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Insider authors

Precious Abraham	Benjamin Lupin
Ann Marie Breheny	Lourdes Martinez
Cindy Brockhausen	Brendan McFarland
Gary Chase	Steve Nyce
Stephen Douglas	Laura Rickey
Maureen Gammon	Kathleen Rosenow
Rich Gisonny	Sylvester J. Schieber
Anu Gogna	Steven Seelig
Russ Hall	Lindsay Wiggins
William Kaltan	

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For permissions and reprint information, please email Joseph Cannizzo at joseph.cannizzo@willistowerswatson.com.

More information can be found on the website: www.willistowerswatson.com.
Publication company
Willis Towers Watson
Research and Innovation Center
800 N. Glebe Road
Arlington, VA 22203
T +1 703 258 7635

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DOL finalizes regular rate of pay rule for overtime purposes

By Stephen Douglas, Rich Gisonny, Laura Rickey and Lindsay Wiggins

The Department of Labor (DOL) has issued **final rules** that update the definition of “regular rate” of pay for purposes of calculating overtime under the federal Fair Labor Standards Act (FLSA). The final rules clarify which perks, benefits and other miscellaneous items must be included in the regular rate.

The updated rules were issued to reflect the evolution of employee compensation packages in the 21st-century workplace. The DOL published a **Fact Sheet** and **highlights** regarding the rules, which take effective January 15, 2020.

General discussion and observations

Under the FLSA, employers generally must pay covered nonexempt employees at least 1.5 times their regular rate of pay for hours worked in excess of 40 per week. An employee's regular rate includes all remuneration for employment, subject to certain exclusions. The final rules clarify that the following payments are among the type that may be excluded:

- The cost of providing certain parking benefits, wellness programs, onsite specialist treatment, gym access and fitness classes (whether onsite or offsite), employee discounts on retail goods and services, employee assistance programs and adoption assistance
- Payments for unused paid leave, including paid sick leave or paid time off
- Reimbursed cell phone expenses, credentialing exam fees, organization membership dues and travel expenses that reasonably approximate the expense incurred
- "Sign on" bonuses with no clawback provision, as well as longevity payments when received as a reward for tenure and not, for example, as part of a collective bargaining agreement
- Pay for time that would not otherwise qualify as "hours worked," including bona fide meal periods unless the parties have treated the time as hours worked
- Tuition programs, such as reimbursement programs or repayment of educational debt, regardless of whether the payment is made to an employee, an education provider or a student loan program
- Certain overtime premiums, regardless of whether a prior formal contract or agreement exists

The DOL also includes examples of "discretionary bonuses" that may be excluded from the regular rate and clarifies that a bonus's label does not determine whether it is discretionary. Such bonuses might include those awarded for unique or extraordinary efforts outside of established criteria, severance bonuses, bonuses for overcoming challenging or stressful situations, referral bonuses and employee-of-the-month bonuses.

In addition, the DOL provides examples of benefit plans, including accident, unemployment and legal services, that may be excluded from the regular rate of pay. The final rules also clarify that while many pension and welfare plan contributions are excludable, there are exceptions that may cause these

An employee's regular rate includes all remuneration for employment, subject to certain exclusions.

amounts to be part of employees' regular rate (e.g., when cash is paid in lieu of plan participation or when a benefit is tied to conditions related to quality or quantity of work performed).

Finally, the DOL makes two substantive changes to the existing regulations. First, "call-back" pay and other similar payments are no longer required to be "infrequent and sporadic" to be excludable from the regular rate; however, they still may not be so regular that they are essentially prearranged. Second, the department updates its "basic rate" regulations, which under the FLSA are an alternative to the regular rate under specific circumstances. Under current regulations, employers may exclude from the overtime computation any additional payment that would not increase total overtime compensation by more than \$0.50 a week on average for overtime weeks during the payment period. The new rules change the \$0.50 limit to 40% of the higher of the applicable local, state or federal hourly minimum wage.

Going forward

Employers will want to review their current practices to determine whether any payroll-related changes are required or advisable after the regulations take effect. When state law differs, the stricter requirement should be applied.

For comments or questions, contact Stephen Douglas at +1 203 326 6315, stephen.douglas@willistowerswatson.com; Rich Gisonny at +1 203 351 5122, rich.gisonny@willistowerswatson.com; Laura Rickey at +1 214 530 4215, laura.rickey@willistowerswatson.com; or Lindsay Wiggins at +1 213 337 5844, lindsay.wiggins@willistowerswatson.com.

IRS issues Required Amendments List for 2019

By Gary Chase and Bill Kalten

In **Notice 2019-64**, the IRS issued its 2019 Required Amendments (RA) List for individually designed qualified and 403(b) retirement plans. The deadline for adopting any amendment on the 2019 RA List is December 31, 2021 (i.e., the end of the second calendar year following the year of publication).¹ “Discretionary amendments” must still be adopted by the end of the plan year in which the plan amendment is put into effect.²

The RA List is divided into two parts. Part A covers changes in qualification requirements that would require an amendment to most plans or to most plans of the type affected by the change. Part B includes changes in qualification requirements that do not affect most plan sponsors but might require an amendment because of an unusual plan provision in a particular type of plan.

The 2019 list has two Part A amendments and no part B amendments. The Part A amendments include:

- Final regulations for hardship distributions require an amendment to eliminate the suspension of an employee’s elective deferrals or contributions as a condition for obtaining a hardship distribution and to require a representation from an employee who requests a hardship distribution regarding the need for the distribution.³

- Final regulations regarding cash balance/hybrid defined benefit plans require an amendment for certain collectively bargained plans to provide for a market-rate-of-return requirement and satisfy other requirements.

Going forward

Plan sponsors should review the 2019 RA List to determine whether to incorporate any of the items into their plans. They should also consider having their plans reviewed periodically to ensure amendments are adopted on time, in light of the IRS’s elimination of cycle-based submissions under its determination letter program for qualified plans, and the newly established deadlines to adopt amendments for 403(b) plans.

For comments or questions, contact Gary Chase at +1 212 309 3802, gary.chase@willistowerswatson.com; or Bill Kalten at +1 203 326 4625, william.kalten@willistowerswatson.com.

¹ For more information on the amendment timing requirements, see “[IRS provides guidance on future determination letter program](#),” *Insider*, August 2016 (for qualified plans) and “[New IRS 403\(b\) plan document compliance program](#),” *Insider*, December 2019 (for 403(b) plans).

² In addition to the annual RA List, the IRS also publishes an [Operational Compliance List](#), outlining changes in the qualification requirements that need to be reflected in plan operations because of a statutory or regulatory change before it shows up on the RA List.

³ For more information on the final regulations for hardship distributions, see “[IRS final guidance on hardship distribution changes](#),” *Insider*, October 2019.

Puerto Rico 2020 retirement plan limits

By Stephen Douglas, Bill Kalten and Lourdes Martinez

The Puerto Rico Treasury Department recently issued **Circular Letter 19-17** (Spanish version) announcing the 2020 benefit limits for defined benefit (DB) and defined contribution (DC) retirement plans qualified under the Puerto Rico tax code. These limits restrict contributions made to and benefits paid from these plans, as well as the amount of compensation that can be taken into account for qualified retirement plan purposes.

The qualified retirement plan limits are effective for the taxable year beginning on or after January 1, 2020.

Going forward

Sponsors of dual-qualified plans and plans qualified solely in Puerto Rico should update their administrative processes and systems to reflect the 2020 limits. These sponsors should also review their administrative procedures to ensure the limits are being monitored.

For comments or questions, contact Stephen Douglas at +1 203 326 6315, stephen.douglas@willistowerswatson.com; Bill Kalten at +1 203 326 4625, william.kalten@willistowerswatson.com; or Lourdes Martinez at +1 786 552 1126, lourdes.martinez@willistowerswatson.com.

Puerto Rico qualified plan limits	2019	2020
Maximum recognizable compensation	\$280,000	\$285,000
Highly compensated employee (HCE) ¹	\$125,000	\$130,000
Annual benefit limit (DB)	\$225,000	\$230,000
Annual contribution limit (DC)	\$56,000	\$57,000
Limit on pretax elective deferrals		
Qualified only in Puerto Rico		
- Contribution limit	\$15,000	\$15,000
- Catch-up contribution limit (age 50 or older)	\$1,500	\$1,500
Dual qualified in Puerto Rico and U.S. (higher limits optional at plan sponsor's election)		
- Contribution limit	\$19,000	\$19,500
- Catch-up contribution limit (age 50 or older)	\$1,500	\$1,500

Limit on after-tax contributions: 10% of the participant's maximum recognizable compensation for all the years of participation in the retirement plan

¹ Early in 2017, the Puerto Rico Internal Revenue Code was amended to implement a fixed \$150,000 compensation threshold for HCEs, rather than linking the threshold to a cost-of-living-adjustment (COLA) dollar amount (as in the U.S. Internal Revenue Code). In December 2018, however, Puerto Rico amended the tax code to, among other things, reinstate the COLA threshold. Note, however, that the change adopted in 2017 that excluded "officers" from the definition of HCE remains in effect.

News in Brief

Appeals court holds ACA individual mandate unconstitutional

By Anu Gogna and Ben Lupin

The U.S. Court of Appeals for the 5th Circuit issued its **opinion** that the individual mandate provision of the Affordable Care Act (ACA), requiring that most Americans enroll in health coverage, is unconstitutional.

As background, on December 14, 2018, in *Texas v. Azar*, a federal judge in the U.S. District Court for the Northern District of Texas held that previous congressional action eliminating the individual mandate penalty (as of January 1, 2019) renders the ACA individual mandate unconstitutional. The judge further reasoned that because Congress labeled the individual mandate as "essential" to creating effective health insurance markets, it could not be severed from the rest of the ACA, and therefore the entire

law is invalid. That decision was subsequently appealed to the 5th Circuit Court of Appeals.

The federal appeals court agreed with the District Court and held that the ACA individual mandate is unconstitutional because it is no longer permissible under Congress's taxing power. However, the court *did not* rule on the severability issue, instead sending the question back to the District Court as to whether the rest of the ACA law can stand without the individual mandate.

As the individual mandate penalty had already been reduced to zero, the ruling has little practical effect and leaves the ACA in place for now. Employers should maintain status quo as this litigation continues.

Social Security reform: A call for facts, transparency and fairness

By Sylvester J. Schieber

As 2019 drew to a close, Social Security remained a political football. Senate Majority Leader Mitch McConnell and other Republicans believe that entitlement spending – of which Social Security is a major component – must be reined in to close the program’s financing gap and control spiraling federal deficits. Coming from the other side of the aisle, the Social Security 2100 Act proposes to restore solvency to Social Security and give everyone bigger benefits by raising payroll taxes. On October 29, a bipartisan group of senators introduced the Time to Rescue United States’ Trusts (TRUST) Act, which would task congressional committees with developing legislation to restore and strengthen the Social Security trust funds.

One of the few points of agreement among sparring politicians is that the system cannot deliver all the benefits promised under current law. Over the 75-year projection period covered in the 2019 Social Security Trustees Report, obligations exceeded assets (including expected revenue) by \$13.9 trillion or 2.78% of projected covered payroll.

Much of the political discourse about Social Security is built on enduring misperceptions, particularly about the finances of retirees, and some of the proposals afoot would remake the system into something it was never intended to be, at least thus far. The cost of the proposed reforms generally would land much harder on younger generations than on older ones.

This article describes Social Security’s early days and policy goals, and estimates the effects of delaying financing reform across several generations. The estimates start with people born in 1946 and include those born in subsequent 10-year intervals through 2006. Slightly out of the pattern, the youngest group includes children born in 2012, many of whom will be finishing college around 2033 or 2034, when the system must either raise more money or pay out less. Young adults coming of working age at that juncture could be picking up the tab for debts incurred before they were born. The article also looks at the Social Security 2100 Act in terms of the program’s enduring principles and generational equity, and offers some suggestions for financing alternatives that would be fairer to all.

Goals and challenges baked into the beginning

President Franklin Roosevelt believed that Social Security should function as an insurance system. He was adamantly opposed to using general revenues because “when the funds are raised from taxation only a ‘means test’ must necessarily be made a condition of the grant of pensions.” In that observation, President Roosevelt was talking about revenues raised from the income tax. He felt differently about financing Social Security through a payroll tax on workers’ earnings because he believed that those payroll taxes were the equivalent of paying premiums into an insurance system.

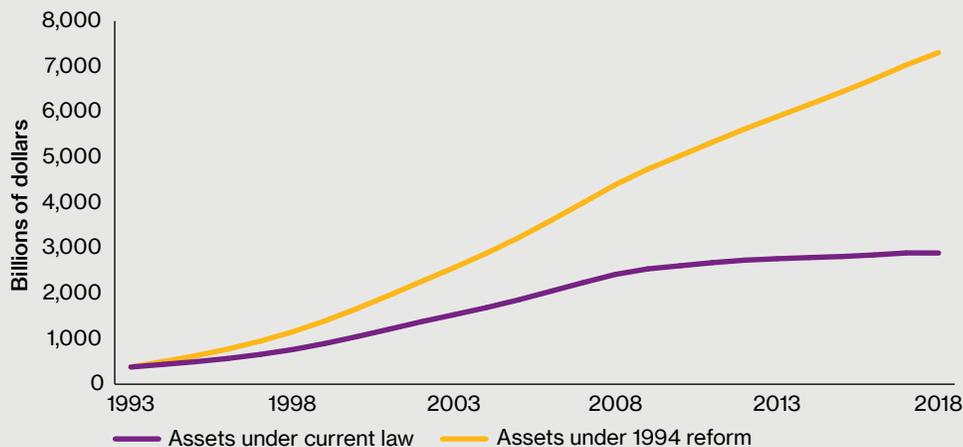
The Social Security Act of 1935 called for payroll taxes to be phased in gradually and the system to operate under Roosevelt’s “insurance principles,” with workers’ benefits being secured by reserved funds. In order to pay early contributors a reasonable benefit, the original law anticipated some early unfunded liabilities but expected those to be fully amortized in roughly 40 years. But notwithstanding protests and a rare veto from FDR, Congress repeatedly slowed payroll tax increases and enhanced benefits, essentially shifting the financing from a reserve-funded system to pay-as-you-go by the early 1950s.¹ Under pay-as-you-go financing, the “actuarial balance” of projected long-term revenues and expenditures became the measurement of financial health. The system has been considered to be in “close actuarial balance” if projected revenues plus existing assets are within 5% of program costs over a 75-year projection period.

In the early decades of the program’s operations, this worked fine, but the financing went badly off the rails during the 1970s. A glitch in a 1972 congressional amendment to automatically index benefits to inflation resulted in the double indexing of initial benefits precisely as inflation soared from 1973 to 1980. From a longer-term perspective, demographics started working against pay-go financing as the post-World War II surge in fertility rates ended.

A congressional fix in 1977 failed to restore the balance, prompting additional amendments in 1983, which were supposed to secure the system’s financing for the baby boom generation’s retirement. At year-end 1983, the Social Security trust funds held \$24.9 billion, representing 14.5%

¹ See Sylvester J. Schieber, *The Predictable Surprise: The Unraveling of the U.S. Retirement System* (Oxford: Oxford University Press, 2012).

Figure 1. OASDI year-end accumulations under existing law versus under 1994 reform scenario



Sources: Trustees, Social Security, *The 2018 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (June 2018), found at: <https://www.ssa.gov/oact/TR/2018/index.html>; and calculations by the author.

On our current trajectory, the 2018 projections show the trust funds dropping to around \$350 billion in 2033 and being depleted in 2034.

of system costs that year. By 1986, asset holdings reached \$46.9 billion or 23.3% of that year’s costs. Despite these short-term gains, however, the 1987 Trustees Report showed that Social Security’s long-range average income rate was 100.6% of projected average costs under the Intermediate II-A assumptions but only 95.4% under the Intermediate II-B assumptions.² Roughly four years after the 1983 legislation had supposedly put the program on a solid financing basis for the next 75 years, the traditional marker of financial health was projecting problems ahead.

According to the 1989 Trustees Report, revenue would reach 99.4% of projected costs under the II-A assumptions and 94.9% under the II-B assumptions over the 75-year period. In 1990, the trustees projected that the income rate would be 97.7% of the cost rate for the 1990 – 2064 period under the II-A assumptions but only 93.5% under the II-B assumptions.

The system has not been in close actuarial balance for the past 30 years, and the trustees have been urging policymakers to make the system solvent since 1991. By 1997, the trustees were emphasizing urgency: “It is important to address both the OASI [Old-Age and Survivors Insurance] and DI [Disability Insurance] problems soon to allow time for phasing in any necessary changes and for workers to adjust their retirement plans to take account of those changes.” The Social Security Advisory Board also began calling out the urgency of reform in its “Social Security: Why Action Should Be Taken Soon” reports, which were published in 1998, 2001, 2005 and 2010.

There are more choices available earlier; changes can be phased in more gradually; the cost of repairing Social Security can be spread more evenly over more generations of workers and beneficiaries; the longer change is delayed, the heavier the impact will be on each individual who is affected; there will be more advance notice for those who will be affected, so they can plan for their retirement; confidence in the ability of Social Security to pay benefits to future generations of retirees will be strengthened; there will be less disruption in labor market participation; there will be less disruption in decisions about consumption and saving (Social Security Advisory Board, 2005, pp. 22 – 23).

Macro costs of delaying reform

The 2018 Trustees Report projected that the 75-year actuarial balance in the Old Age, Survivors and Disability Insurance (OASDI) program was –2.84% of covered payroll (\$13.2 trillion) and stated that, absent reform, the system would not be able to pay all benefits in 2034. Had Social Security’s financing shortfalls been addressed when the problem was first identified more than a quarter century ago, the current outlook would be much different.

At year-end 1993, the 75-year financing shortfall was estimated at 2.13% of covered payroll, which could have been closed by raising future payroll tax rates, reducing benefits or some combination of the two. As shown in *Figure 1*, at year-end 2018, the aggregate trust funds held around \$2.8 trillion

² As stated in the *1987 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (June 1987): “Alternative II-A assumes future economic performance resembling that of the more robust recent economic expansions... Alternative II-B assumes the adoption of policies which would result in an economic performance resembling less robust economic expansions.”

Figure 2. Social Security payroll tax obligations on generations under alternative reform scenarios

Birth year (1)	Lifetime OASDI tax collections in equivalent years of average earnings					
	Cost under current law (2)	Cost under 1994 reform (3)	Net cost, 1994 fix vs. current law (4)	Cost under 2034 reform (5)	Net cost, 2034 fix vs. current law (6)	Net cost, 2034 fix vs. 1994 fix (7)
1946	5.10	5.37	-0.27	5.10	0.00	0.27
1956	5.35	5.88	-0.53	5.35	0.00	0.53
1966	5.37	6.20	-0.83	5.37	0.00	0.83
1976	5.36	6.29	-0.93	5.59	-0.23	0.70
1986	5.42	6.36	-0.94	6.06	-0.64	0.30
1996	5.45	6.39	-0.94	6.55	-1.10	-0.16
2006	5.46	6.39	-0.93	7.01	-1.55	-0.62
2012	5.46	6.39	-0.93	7.20	-1.74	-0.81

Source: Sylvester J. Schieber, "Alice in Wonderland... or Is It Plunderland?: The Generational Implications of Social Security Financing Policy and New Proposals to Expand Benefits," *Journal of Retirement* (Fall 2019), vol. 7, no. 2, pp. 8 – 40, found at: <https://jor.pm-research.com/content/7/2/8>.

but the holdings had flipped from growing to shrinking, as total costs were projected to exceed payroll tax income and interest. Had reforms been implemented in 1994, the year-end balance would be roughly 2.5 times larger and growing. On our current trajectory, the 2018 projections show the trust funds dropping to around \$350 billion in 2033 and being depleted in 2034. Under current law and projections, benefits will have to be reduced by 20% to 25% when the trust fund balance drops to zero.

Using the assumptions from the 2018 Trustees Report, under the 1994 reform scenario, the trust funds would accumulate to around \$12.9 trillion in 2033 and continue to grow until around 2087 before beginning to decline. In fact, under the 1994 reforms, trust fund assets would amount to 1.46 times benefits paid in 2095.

Assuming that policymakers continue sitting on their hands until 2033, they will have to raise revenues, cut benefits or some combination of the two. According to the 2018 Trustees Report, Social Security's costs will exceed revenues by around 3.3% of covered payroll in 2034. But increasing payroll taxes by 3.3% would not cover costs over the 75-year projection period. Once again, based on assumptions and projections from the 2018 Trustees Report, the federal government would have to increase payroll taxes by at least 3.98% – 1.99% on employers and 1.99% on workers – to restore actuarial balance to the system.

Had reforms been implemented in 1994, the year-end balance would be roughly 2.5 times larger and growing.

Micro costs of delaying reform

While comparing the costs of rebalancing Social Security financing in 1994 versus 2034 shows the costs of delay – 2.13% against 3.98% of covered payroll – it does not indicate who would pay the difference. Delaying reforms until 2034 would almost certainly boost the lifetime incomes of workers born in the 1940s and 1950s and likely reduce lifetime incomes of those born after 2000.

To fill in the details, we used the "Hypothetical Earnings Examples" developed regularly by the Social Security Administration to estimate the effects of alternative policies on different age groups. Four of the earnings levels are linked to average wages, while the fifth simply follows the path of maximum annual earnings subject to the payroll tax. In the following estimates, career average earnings equal 25% of the average wage index (AWI) for very low earners, 45% of the AWI for low earners, 100% of the AWI for medium earners and 1.6 times the AWI for high earners.

Figure 2 compares the estimated lifetime payroll taxes that were paid or would be paid by each age group under current law with the taxes they would have paid or would pay under the 1994 reform scenario. We also estimate lifetime payroll

Delaying reforms to Social Security has shifted a much larger share of the financial burden to younger generations.

taxes if policymakers increase payroll taxes by 4% in 2034 (the doomsday date). The lifetime payroll tax for a worker in the table is not shown as a percentage of annual earnings but the total lifetime collections stated as the equivalent number of years of average earnings that are collected over a worker's career.

Column (2) shows the years of average earnings that were or will be paid as payroll taxes for each birth cohort under current law. Earlier birth cohorts pay less than later ones because payroll tax rates were much lower in the 1960s and 1970s than in later years. The combined employer and employee payroll tax rate was 7.7% in 1967, 9.9% in 1977, and 12.4% in 1990 and all years thereafter under current law.

Column (3) shows the outcome of a 2.13% payroll tax increase in 1994 for different age groups, and column (4) compares the relative costs for each cohort to current law. For workers born in 1946, the 1994 payroll tax increase would have claimed slightly more than an additional quarter year of average annual lifetime earnings. The claim would have risen to slightly more than half a year for the 1956 birth cohort and to around 93% of average annual lifetime earnings for the 1976 and later cohorts.

Column (5) shows what would happen if payroll taxes increase by four percentage points in 2034, and column (6) compares those reform costs with current law costs. A 2034 fix would largely spare the 1946 – 1966 birth cohorts but would burden the 1976 birth cohort by an extra one-quarter of one year of average lifetime earnings, rising to 1.74 years of average earnings for those born in 2012.

Column (7) shows the effects on lifetime income of delaying reform to the doomsday date compared with the financing shortfall having been addressed in 1994. Those born in 1946 gain around a quarter of a year of earnings, while those born 10 years later come out a half-year ahead. The 1966 and 1976 birth cohorts gain 83% and 70% of average annual earnings, respectively, while the gains drop to a much lower 30% for those born in 1986. The losers are those born from the mid-1990s and later: The 2012 birth cohort would pay an extra 80% or so of an average year's pay. Delaying reforms to Social Security has shifted a much larger share of the financial burden to younger generations.

The politics of Social Security financing policy

When Bill Clinton was president, he told a gathering of Georgetown University students that, unless we remedied Social Security's upcoming deficits, funding the system would reduce their incomes and, in turn, their ability to take care of their children. Unfortunately, scandals in his second term sidelined any progress he might have made toward reform. George W. Bush promised Social Security reform in his 2000 presidential campaign and made it a legislative priority after his reelection four years later, but the president was unable to sell his proposals to the Democrats or the public. Shortly after taking office in 2009, Barack Obama told *The Washington Post*:

As soon as economic recovery takes place, then we've got to bend the curve and figure out how we get federal spending on a more sustainable path...

We are also going to have a discussion about entitlements and how we get a grasp on those... As bad as these deficits that have already been run up have been, the real problem with our long-term deficits, actually, have to do with our entitlement obligations...

So we're going to have to shape a bargain. This, by the way, is where... some very difficult issues of sacrifice, responsibility and duty are going to come in because what we have done is kick this can down the road and we are now at the end of the road. We are not in a position to kick it any farther...³

But by the time President Obama neared the end of his second term, progressive Democrats were making a case for expanding Social Security benefits. They based their proposals, at least in part, on claims from advocacy groups that Social Security was the only income source for many retirees and the only secure one for most, and that replacing traditional pensions with 401(k) plans had diverted a significant share of retirement savings into the pockets of fund managers and intermediaries.

In January 2019, Representative John Larson, along with 200 co-sponsors, introduced the Social Security 2100 Act in the House of Representatives, and Senators Richard Blumenthal and Chris Van Hollen introduced the bill in the Senate. The Social Security 2100 Act would:

- Raise the replacement rate of average indexed monthly earnings (AIME) from 90% to 93%, starting in 2020. According to Social Security actuaries, this would increase

³ Obama, Barack, Interview transcript with the editorial board of *The Washington Post* (January 16, 2009), found on 24 April 2019 at: <http://www.washingtonpost.com/wp-dyn/content/audio/2009/01/16/AU2009011601671.html?sid=ST2009011504146#>.

the average cost of the pension system by 0.26% of covered payroll over the 75-year projection period.

- Change the index used for cost-of-living increases from the CPI-W to the CPI-E (consumer price index for the elderly), which the actuaries estimate would cost an extra average of 0.40% of covered payroll over the 75-year projection period.
- Increase the minimum initial primary insurance amount for workers eligible for retirement or disability benefits to 125% of the federal poverty line for single individuals with 30 or more years in the system (the benefit would be adjusted on a pro rata basis for workers with fewer years of coverage). The actuaries estimate this provision would cost an average of 0.12% of covered payroll per year over the projection period.
- Increase the federal income tax thresholds on up to 85% of Social Security benefits to \$50,000 for single filers and \$100,000 for couples.⁴ This provision is estimated to cost an average of 0.16% of covered payroll for the projection period.
- Impose payroll taxes on all earnings over \$400,000 per year starting in 2020 and increase benefits by 2% of the higher AIME. This provision would increase revenues an average of 1.90% of covered payroll over the 75-year projection period.
- Increase the payroll tax rate on all workers and employers by 0.05% each starting in 2020 and ending in 2044, thereby increasing the rate from 12.4% to 14.8%. This would raise an average of 1.81% of covered payroll per year over the projection period.

The combined proposals would both balance the system and pay for the higher benefits, as well as create a 0.25% surplus over the 75-year projection period.⁵ In a generational context, the Social Security 2100 Act would soften the burden on future rank-and-file workers by imposing higher taxes on their higher-earning counterparts.

Assumptions versus reality

Recent proposals to give retirees larger Social Security benefits are generally based on certain assumptions. First, retirees paid payroll taxes while they worked, and it would be unfair to change the rules when it's time for them to collect. Second, retirees generally have less money and flexibility than workers, so it's easier for workers to make economic

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adjustments. But the argument cited most often is that the elderly are entirely or largely dependent on Social Security to survive. In the press release announcing the Social Security 2100 Act, Representative Larson claimed that “Social Security is the most important source of retirement income for 4 out of 5 seniors.” Interest groups have flooded the public with messages about the inadequacy of benefits and retirees’ lack of other income sources. The Social Security Administration has also published data for years that exaggerate the dependence of older Americans on its benefits.

The “fairness” argument fails to acknowledge that the rules in place were unfair to future generations. Under the Social Security 2100 Act, those born in 2012 would face higher payroll tax rates from the first day of their careers and be about a decade into their working careers when the higher payroll taxes took full effect. A worker with 35 years under the reformed system would give up an extra year’s pay to meet the extra 2.8% payroll tax compared with current law.

The premise that retirees struggle under limited incomes is true for some retirees but certainly not all. According to our tabulations of the Census Bureau’s *Annual Social and Economic Supplement* to the *Current Population Survey* (CPS), 58.6% of people ages 65 and older reported Social Security income as their largest single source of income for 2014, 59.3% in 2015, 58.0% in 2016 and 57.4% in 2017 – considerably less than the 80% claimed by Representative Larson.

Moreover, a number of researchers have found that the CPS greatly exaggerates Social Security’s share of retirement income and underreports other retirement income, which is captured elsewhere, including federal tax filings. One explanation is that the survey traditionally has asked respondents to report regular payments such as wages and Social Security benefits but has left out distributions from defined contribution accounts or IRAs. The biggest shortfall in CPS reporting has been on income received from retirement plans other than Social Security, where self-reports captured only 47.6% of income reported on federal tax forms.⁶ In 2018,

⁴ Under current law, single tax filers with combined “income” greater than \$25,000 may have to pay income tax on up to 50% of their Social Security benefits. If combined “income” exceeds \$34,000, up to 85% of benefits may be taxable.

⁵ See Stephen C. Goss, letter evaluating financial effects on Social Security of the Social Security 2100 Act (30 January 2019), found on 25 April 2019 at: https://www.ssa.gov/oact/solvency/LarsonBlumenthalVanHollen_20190130.pdf.

⁶ Adam Bee and Joshua Mitchell, “Do Older Americans Have More Income than We Think?” U.S. Census Bureau, SEHSD Working Paper #2017-39 (July 2017), found on 16 April 2019 at: <https://www.census.gov/library/working-papers/2017/demo/SEHSD-WP2017-39.html>.

the Social Security Administration recognized that the CPS did not accurately capture the income of older Americans in its “Fast Facts & Figures about Social Security, 2018.” The report states:

We are suspending publication of the five charts that constitute the Income of the Aged Population section for the 2018 edition of *Fast Facts and Figures* as we evaluate the adequacy of the charts’ data source, the Annual Social and Economic Supplement (also known as the March Supplement) of the Current Population Survey (CPS). Recent research suggests that there may be some issues with the measurement of certain sources of income reported in the CPS. We are dedicated to publishing the most accurate statistics possible so we are conducting a thorough review of available data sources for these publications and will publish findings from this review. For more information, see Bee, Adam and Joshua W. Mitchell. 2017. “Do Older Americans Have More Income Than We Think?” SEHSD Working Paper No. 2017-39. Washington, DC: U.S. Census Bureau. (Social Security Administration, 2018, p. 5).

Despite this acknowledgement, the Social Security Administration has not revised earlier reports based on the erroneous CPS data, which continue to be cited in policy proposals and discussions about the income status of the elderly.

The Social Security 2100 Act would increase the payroll tax rate by 0.1 percentage points each year, split between the employer and employee, starting in 2020 and continuing through 2043, when the combined rate would reach 14.8%. Plugging these proposed tax rates into the hypothetical working histories used for Figure 2, the lifetime cost of Social Security benefits would represent 6.47 years of average earnings for a medium earner – almost an extra year’s worth of earnings compared with current law.

Both the delay in Social Security reform and the proposed concentration of higher taxes on future generations impose a disproportionate burden on younger generations. Because of its more generous benefits, the Social Security 2100 Act would exacerbate the shift of costs to the young. The proposal would boost Social Security benefits for all beneficiaries immediately, use a price index that would result in higher future cost-of-living increases and reduce income taxes on benefits. Increasing Social Security benefits for longtime low earners makes sense but doing so for well-off older Americans at the expense of their grandchildren does not.

Because of its more generous benefits, the Social Security 2100 Act would exacerbate the shift of costs to the young.

It appears that the proposal’s sponsors are convinced that Social Security benefits are universally “modest” and most of the elderly have no other financial backstop. Just as poverty among the elderly has been overstated, Social Security benefits are not so modest for all retirees.

For a 70-year-old retiree with a long history of maximum earnings, the Social Security benefit is around \$43,500 in 2019, and combined benefits for a same-age high-earning couple who retired at 70 are around \$87,000. To fund \$70,000 worth of Social Security benefits in 2019 would require payroll taxes from 38 minimum-wage workers, 10.5 average-wage workers or 4.25 workers earning maximum payroll-taxable pay.

Furthermore, most retirees are not losing economic ground relative to workers. According to estimates by Bee and Mitchell based on administrative data, between 1990 and 2012, median income for those 65 and older rose by 29%. Incomes rose by 31% in older households at the 25th percentile of the income distribution and by 32% among those at the 75th percentile. According to our comparable calculations, over the same period, median incomes of working-age families declined by 4.6% at the 25th percentile, and grew by 2.3% at the median and by 9.3% at the 75th percentile. Over the past 20 years, the elderly have enjoyed far larger income gains than the workers whose payroll taxes would fund the Social Security 2100 Act. Not only are retirees faring better than the taxpayers working to support them, they also receive highly subsidized health insurance through Medicare and special treatment under the federal income tax and many state and local tax systems.

The proposal to essentially eliminate the payroll tax cap is an entirely different matter. It first appears that eliminating the payroll tax cap would raise massive amounts of revenue with little financial pain. The Social Security 2100 Act would tax all earnings over \$400,000 per year at the full payroll tax rate and give those who paid those taxes greater benefits. The \$400,000 would be fixed over time so the current payroll tax cap (\$137,700 in 2020), which is indexed by average wage growth, would ultimately catch up to the frozen standard. The proposal also would add a new AIME+ tier to the benefit formula that would add a 2% benefit. The Social Security actuaries estimate that eliminating the payroll tax cap would

generate an additional 1.91% of taxable payroll over the 75-year projection period, while the additional benefits would cost only 0.01% of taxable payroll.

The cap on earnings subject to the payroll tax has been in place since the Social Security Act passed in 1935, and it reflects principles that have been considered essential to the system from its beginning. In addition to believing that the pension system should be built on insurance principles, President Franklin Roosevelt also insisted that the system be financed by contributions based on workers' earnings. He wanted workers to believe they had paid for their benefits "so no damn politician can ever scrap my social security program." On the benefit side, workers who contributed to the system during their working years would derive benefits accordingly during their retirement.⁷

Franklin Roosevelt and the economists who advised him in developing the Social Security pension system wanted it to be funded rather than financed on a pay-as-you-go basis because they worried that, in the long run, pay-as-you-go financing would eventually turn Social Security into a bad economic deal for many. For years, the Social Security Administration has published analyses of workers' realized "money's worth," and recent reports suggest Roosevelt's concerns were warranted. An average, single male earner born in 1920 could expect to receive 1.51 times his accumulated taxes and interest, and a single woman born in the same year would receive 1.82 times their value.⁸ For a single-earner couple, the ratio of benefits to contributions was 3.51. For participants born before 1920, the benefits-to-contributions ratio was even more favorable.

In a recent calculation of money's worth ratios – under assumptions that payroll taxes would be raised across the board to cover current-law financing deficits – a single male, medium earner born in 2004 could expect to receive 83% of his lifetime contributions, and his female counterpart could expect 90%. A single-earner couple could look forward to 139%. For high earners, these respective percentages fall to 69%, 75% and 115%; for lifetime maximum earners, they are 52%, 56% and 57%.⁹

Eliminating the cap on taxable earnings and increasing benefits by less than 1% of the additional contributions would be a complete rejection of the principle linking benefits to contributions. Additionally, some elite workers at the top of the

Shifting to a work credit system would reduce the inequities of pushing the Social Security retirement age higher.

earnings distribution could receive a quarter million dollars a year in benefits, which makes little sense for a program whose purpose is to guarantee basic economic security.

If policymakers are willing to abandon some of the basic principles on which Social Security has been grounded for the past 85 years, a 21st-century redesign might make more sense than tinkering at the edges of a system rooted in the 1930s Great Depression. In 1935, the benefits accumulated under tax-qualified retirement plans were trivial compared to today. In 1940, when the first Social Security pensions were paid, only 1% of the beneficiaries who qualified for a retirement annuity based on their own working history were women. A spousal benefit made sense in a world where most women spent their working years as homemakers and the survivor's benefit operated as a close proxy for a joint-and-survivor benefit. In our modern world – where most women earn their own retirement benefits but receive scant added economic gain relative to non-working spouses, especially among couples at the upper end of the earnings distribution – swapping the traditional spousal benefit for a true joint-and-survivor benefit would be much fairer and provide greater retirement income security, especially for widows. While achieving generational equity might suggest further increases to the eligibility age for full retirement benefits, an across-the-board increase would be unfair to lower-earning workers.

Our modern realities pose opportunities as well as conundrums. For example, retirement benefits could be based on work credits rather than historical earnings, which would go a long way to improving retirement prospects among long-career low earners.

Shifting to a work credit system would reduce the inequities of pushing the Social Security retirement age higher. Lower-earning workers are more likely to have physically demanding jobs and to encounter more barriers in finding jobs later in life. Moreover, lower-income workers typically have shorter life expectancies than those higher up the economic ladder. Under a work credit system, a year of covered earnings would qualify for an equal benefit for the housemaid and the corporate executive, and low earners could retire in their

⁷ See Sylvester J. Schieber and John B. Shoven, *The Real Deal: The History and Future of Social Security* (New Haven: Yale University Press, 1999).

⁸ See Stephen C. Goss and Orlo R. Nichols, "OASDI Money's Worth Analysis for Hypothetical Cohorts," Office of the Actuary, Social Security Administration internal memorandum (1 March 1993), p. 5.

⁹ See Michael Clingman, Kyle Burkhalter, and Chris Chaplain, "Money's Worth Ratios under the OASDI Program for Hypothetical Workers," *Actuarial Note Number 2018.7* (January 2019), found on 9 May 2019 at: <https://www.ssa.gov/oact/NOTES/ran7/an2018-7.pdf>.

early or mid-60s if their benefits exceeded their earnings. The more affluent could then be required to meet a later retirement age for Social Security.

Policy and financing reforms must begin with an accurate assessment of the retirement resources in play, targeting benefit improvements where the need is greatest. Over recent decades, there has been a chorus of claims that the widespread shift from traditional defined benefit plans to defined contribution plans has left many workers vulnerable to destitute retirements. But the lower-earning workers who are at greater risk of poverty in retirement were always less likely to be covered by employer-sponsored retirement plans. Enhancing Social Security benefits for lower-earning workers would more effectively ameliorate poverty than trying to bolster employer-sponsored plans.

Widespread underreporting of retirement income from 401(k) plans and IRAs has misrepresented the financial position of many retirees and overlooks vast amounts of retirement savings. Between 2012 and 2016, total income accruing to private employer retirement plans exceeded total income accruing to the Social Security system by 20% – far too much money to ignore. And these plans represent only part of the employer-sponsored retirement system. At year-end 2016, assets in private plans subject to ERISA added

By year-end 2018, employer plan assets equaled \$24.8 trillion: 8.6 times Social Security's trust fund balances.

to those in plans financed through insurance companies and public employers totaled \$23.7 trillion – 8.3 times the assets backing Social Security pensions. By year-end 2018, employer plan assets equaled \$24.8 trillion: 8.6 times Social Security's trust fund balances.

With incomes dropping for the bottom 25% of working households and rising more slowly for higher-income workers than for the elderly, larger Social Security benefits should be reserved for those for whom Social Security is a vital economic lifeline. If health costs for low-income retirees are high enough to warrant a switch to the CPI-E, a dollar cap should be imposed on cost-of-living adjustments, so high-income retirees share the costs of improving retirement for the economically vulnerable. And rather than basing reforms on misrepresentations of need and shifting political winds, policymakers need to bring more facts and fairness to the debate.

*For comments or questions, contact
Sylvester J. Schieber at syl.schieber@gmail.com.*

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