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SOCIAL SECURITY TRUSTEES REPORT: DEMOGRAPHICS, BENEFIT FORMULA, NOT COLAS, DRIVE BIG DEFICITS; GREENSPAN'S MISTAKE

The *2004 Social Security Trustees Report*[1] was released on March 23. It contains a wealth of information, some of it quite surprising, about the future of the Old Age, Survivors, and Disability Insurance program (OASDI). Did you know that, in the face of impending insolvency, Social Security:

- is promising, over time, to pay future retirees benefits that are more than twice the real benefits that current retirees receive?
- will pay some future upper income working couples almost $107,000 a year in real, inflation-adjusted benefits?
- will eventually pay most future two-earner retired couples more in Social Security benefits than the current median family income?
- will eventually require each working couple to support a retiree, due to demographic changes?

All of this is true, and it is revealed in the various tables in the *Trustees Report*. These features of Social Security stem from its basic retirement benefit formula and the demographic changes confronting the System, which are the sources of its large projected deficits. The impact of the annual cost of living adjustment (COLA), which Federal Reserve Chairman Alan Greenspan has recently lamented, pales in comparison.

Most people only look at two bits of data in the *Trustees Report* — the year the system will start running annual cash flow deficits (2018), and when it will run out of spending authority by exhausting its trust fund (2042).[2] Serious students of Social

Security should look beyond these cash flow and trust fund numbers to learn more of why the system is in trouble and what can be done about it. The excellent background material in the Report and its appendices can be of great help.

Promised benefits are soaring in real value, and will more than double by 2080.

Consider Table VI.F11. - Estimated Annual Scheduled Benefit Amounts for Retired Workers (*OASDI Report*, pp. 186-187.) The table (partially reproduced on the next page) shows the ***initial benefits that future generations are projected to receive when they first retire*** after they reach age 65 in future years, 2004 through 2080. (These are their basic starting benefits, ***determined by the benefit formula***. These benefits will later be adjusted for inflation by the annual COLA, which is set by a different formula, and is a different issue.) The initial retirement benefits are displayed in the table for people who earn various levels of wages relative to the rest of the population (low wage, average wage, high wage, and the maximum wage subject to the payroll tax). The benefits are presented in real inflation-adjusted dollars, and as a percent of pre-retirement income. They are shown for people who work until the normal retirement age (rising gradually from 65 to 66 and 67), or who retire at a fixed age of 65 in the years shown.

It is often mentioned that the Social Security benefit formula is structured to provide all generations over time with about the same benefits

relative to pre-retirement income. This is known as a "constant replacement rate," and it is projected to be 55.3 percent for low wage workers (earning 45 percent of the average wage), 41 percent for workers who earn the average wage all their lives, 34 percent for high earnings workers (160 percent of average wage) and 27.3 percent for maximum covered wage workers, assuming they retire at the normal retirement age applicable for their age cohort. What many people do not realize, and what may come as a surprise or shock, is that these "constant replacement rates" actually mean that benefits will rise significantly over time as real wages grow.

Real wages are projected to increase by roughly 130 percent over the 75-year planning period. *A constant percent of a rising real wage means a*

rising real benefit. The average wage worker turning 65 in 2004 will get $14,513 upon claiming benefits at his normal retirement age of 65 years and 4 months. A similar worker turning 65 in 2030 will get $19,183 upon claiming benefits in 2032 at his normal retirement age of 67. A worker reaching age 65 in 2080 will get $32,795 upon claiming benefits at age 67 in 2082. The real benefit for the 2082 retiree will be 226 percent of that of the 2003 retiree, an increase of 126 percent. Those figures are for a single retiree. Add 50 percent for a spouse. If both spouses have worked at these wages, double the amounts.

A retired married professional couple, each having earned the maximum covered wage, would collect between them a total of $43,782 upon

Social Security Benefit Amounts for Retired Workers at Indicated Pre-Retirement Wage Levels In Real Dollars and as Percent of Pre-Retirement Wages Estimates for 2004 to 2080, Intermediate Assumptions

Year Attains Age 65	Age at Normal Retire- ment	Worker with Low Earnings		Worker with Medium Earnings		Worker with High Earnings		Worker with Max Covered Earnings	
		Real 2004 $	Percent of Earnings	Real 2004 $	Percent of Earnings	Real 2004 $	Percent of Earnings	Real 2004 $	Percent of Earnings
2004	65:04	$8,804	57.4	$14,513	42.5	$19,099	35.7	$21,891	30.0
2005	65:06	9,015	57.4	14,854	42.5	19,585	35.6	22,551	29.7
2010	66:00	9,367	55.5	15,433	41.2	20,471	34.1	24,444	28.0
2015	66:00	9,947	55.9	16,390	41.4	21,743	34.4	26,452	27.6
2020	66:02	10,493	55.9	17,291	41.5	22,933	34.4	28,045	27.5
2030	67:00	11,645	55.4	19,183	41.1	25,436	34.0	31,330	27.3
2040	67:00	12,962	55.3	21,357	41.0	28,315	34.0	34,850	27.2
2050	67:00	14,452	55.4	23,811	41.0	31,572	34.0	38,790	27.3
2060	67:00	16,080	55.4	26,493	41.1	35,124	34.0	43,154	27.3
2070	67:00	17,887	55.3	29,469	41.0	39,069	34.0	47,996	27.3
2080	67:00	19,906	55.3	32,795	41.0	43,478	34.0	53,411	27.3

Source: OASDI Trustees Report, 2004, Table VI.F11.

claiming benefits in 2004 at age 65 and 4 months, $62,660 if claiming benefits at age 67 in 2032, and $106,822 upon starting benefits at age 67 in 2082. We are promising some future (2080) upper income retirees an annual real benefit that is almost twice the current nationwide median family income ($57,500 in 2004)[3], and that would be in addition to any pension or savings income that this upper income couple had accumulated. Rising real benefits, marching upward in lock-step with the growth of per capita real wages (and the rising cap on earnings subject to the payroll tax), are a key part of the OASDI system's projected slide into deficit.

Workers to support the system are getting scarce.

The other key cause of the coming deficits is the declining ratio of workers to retirees, projected to fall from 3.3 currently to 2.2 by 2030 (when most of the baby boom generation will have retired) and to 1.9 by 2080. (See Table IV.B2. - Covered Workers and Beneficiaries, pp. 47-48, intermediate assumptions.) If the working population were keeping up with the number of retirees (producing a constant ratio of taxable wages to promised benefits), the System could afford to pay a constant replace-ment rate without having to raise the payroll tax rate. But with the ratio of workers to retirees falling by about 45 percent, either the replacement rate must fall by about 31 percent or the payroll tax rate must rise by about 48 percent, from 12.4 percent to 18.4 percent of taxable payroll for OASDI, excluding Medicare. That is the rate that would be needed to close the outyear deficits. *Why should a "social*

insurance safety net" tax future low income workers 18.4 percent of their wages to pay retirement benefits of almost $107,000 a year in real 2004 dollars to an upper income couple? Even worse, when one adds the Medicare tax, the combined payroll tax rate would be 31.27 percent![4]

Just trimming the *growth* of benefits growth can minimize the pain of fixing the system.

These tables make an important point. Since initial real retirement benefits are projected to more than double under current formulas, it is possible to offset much of the projected OASDI deficit by trimming the growth of initial benefits, either across the board or for middle and upper income beneficiaries, without actually having to cut benefits in real terms from one generation to the next. In 1994, Representatives Dan Rostenkowski (then Chairman of the House Ways and Means Committee) and J.J. Pickle (then Chairman of the Ways and Means Social Security Subcommittee) each introduced legislation containing gradual changes in the benefit formula that would have achieved that result (H.R. 4245 and H.R. 4275, respectively). President Bush's Social Security Reform Commission, in one of its options, went so far as to suggest that real benefits be frozen at 2008 levels.

The COLA is a separate issue.

Recently, Federal Reserve Chairman Alan Greenspan criticized the annual cost of living

Covered Workers Per OASDI Beneficiary Intermediate Case	
Year	Workers Per Beneficiary
2000	3.4
2005	3.3
2010	3.2
2015	2.9
2020	2.6
2025	2.3
2030	2.2
2035	2.1
2040	2.0
2045	2.0
2050	2.0
2055	2.0
2060	2.0
2065	1.9
2070	1.9
2075	1.9
2080	1.9

Source: OASDI Trustees Report, 2004, Table IV.B2.

adjustment (COLA) that is given to retirees' benefits, suggesting that it is about half a percent a year too generous, and that it is contributing to the system's projected deficit. He is making a mountain out of a molehill and ignoring the actual Alp in the backyard. The formula that determines initial benefits upon first retiring has a far greater impact on the OASI system than does the COLA. Retirees live, on average, about twenty years past normal retirement age. Trimming the COLA by half a percent a year would trim benefits in the last year of (average) life by only about ten percent, and would reduce average benefits over a typical retirement by only about half that, or five percent. Since the reduction in benefits would die out with each retiree, and each new entrant would come into the system under the existing benefit formula, the system's savings would never exceed about five percent. The projected *more than doubling* of initial benefits over the planning period due to the benefit formula dwarfs the five percent differential that tinkering with the COLA might achieve.

Chairman Greenspan headed the 1982-1983 Social Security Commission that recommended reforms to stave off insolvency that was looming in the mid-1980s for OASI. One of the recommendations of that Commission was a delay in the COLA. The Congress later adopted a six month delay in the 1983 Social Security Amendments. The same Commission also recommended taxing up to half of benefits, trimming survivors benefits, and raising the normal retirement age, which were also adopted. (The benefits tax was later expanded in 1993 to cover up to eighty-five percent of benefits.) Only the retirement age increase had a significant effect on the system's long run outlays, and a limited one at that. Consequently, the deficits grew back quickly.

When the Commission was working, I was Deputy Assistant Secretary of the Treasury for Economic Policy. The Department's key expert on Social Security was Dr. Aldona Robbins, now at Fiscal Associates. Dr. Robbins and I invited Dr. Greenspan to consider a change in the initial benefit formula to bring about a very gradual reduction in the growth of real benefits, which would have

reduced the outyear deficits by $3 trillion in present value (as of 1983).[5] Greenspan was dissuaded from adopting the change by the chief of staff of the Commission, former chief actuary Robert Myers, who had been instrumental in developing the benefit formula while at SSA, and who did not want to see the System's role in providing retirement income slip in relative terms vis-a-vis personal saving and pensions. Having missed a chance to address the real problem of the benefit formula in 1983, Chairman Greenspan is still focusing on COLA adjustments that are as ineffective now as they were then.

The COLA is not the source of the system's deficits. It makes little sense to give people a certain initial benefit, and then let it be whittled away by inflation. If the initial benefit formula is giving real benefits that are deemed to be too high, then fix the initial real benefits, and then give them a full COLA. Greenspan argues that the national CPI index may overstate inflation by a small amount. That is possible, but the cost of living for the elderly may be rising a bit faster than that of the average citizen due to heavy outlays for medical care, not all of which is covered by Medicare or the new prescription drug benefit.

Personal saving and pension arrangements can cushion the transition.

Of course, trimming benefit growth would make Social Security's retirement system, already a bad financial investment compared to private saving, an even worse deal. But raising taxes to cover projected benefits would also lower the rate of return, and would be the worst deal of all, because holding more of a bad investment is worse than holding less of a bad investment. Fortunately, the adverse effects could be offset by allowing people to put some of their Social Security tax "contribution" aside to earn a higher return in a personal pension fund invested in private sector stocks and bonds. That arrangement would require the federal government to trim its own spending to pay for the diversion of the payroll tax. That is only fair, because the government should never have promised these unaffordable benefits to begin with, knowing

that the worker/retiree ratio was bound to drop. If future Congresses have less money to spend because of the misbehavior of past Congresses, so be it. Better that than putting a crushing tax burden on future workers.

Sensitivity tables suggest faster wage growth and immigration could help the system.

The *Trustees Report* appendices also present "sensitivity tables" showing how the system's outlook would change as the assumptions about productivity, wages, and population growth are altered. For example, a rise in real wage growth (the "real wage differential") from 1.1 percent annually to 1.6 percent would trim the projected 75 year deficit (the "actuarial balance") by about 29 percent, and delay trust fund exhaustion by 6 years. (Table VI.D4. - Sensitivity to Varying Real-Wage Assumptions, p. 152.) On an annual basis (not shown) the saving would taper off to about 24 percent of the deficit in 2080. Growth economists have long pointed out that real wages might rise that much faster if the multiple layers of tax imposed on saving and investment under the current income tax system were eliminated, boosting productivity increases that drive real wages. This suggests that fundamental tax reform would be a good way to address part of the pending retirement problem.

Another policy step that would help OASDI would be to increase immigration. An increase in immigration from an assumed 900,000 per year to 1,300,000 per year would trim the projected 75 year deficit by nearly 14 percent, and would delay trust fund exhaustion for 2 years. (Table VI.D3. - Sensitivity to Varying Net Immigration Assumptions, p. 150.) On an annual basis (not shown) the saving would taper off to about 10 percent of the deficit in 2080. Even with such improvements, it would still be necessary to shift over time to a system of personal accounts, but the transition would be much easier with a more rapidly growing economy.

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Endnotes

1. *The 2004 Annual Report of the Board of Trustees of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, Social Security Administration, Washington, DC, March 23, 2004.

2. The OASDI program's outlays will exceed its tax revenue in 2018. Thereafter, OASDI must use some of the interest payments that the trust funds receive from the Treasury to cover part of its outlays, instead of lending the interest back to the Treasury. At that point, OASDI will be adding to rather than reducing the total federal budget deficit, and will require real money from the Treasury instead of just a paper IOU. Treasury will have to increase its borrowing from the public to pay a portion of the OASDI benefits (unless the rest of the federal budget is in sufficient surplus to cover the interest payments.) A decade later, in 2028, OASDI's cash deficit will exceed its interest income, and it will have to begin drawing on the budget authority represented by its "trust funds" holdings of Treasury debt. When that happens, Treasury will similarly have to redeem trust fund principal by raising money in the credit markets, borrowing from the public to cover the "redemptions." OASDI will exhaust the spending authority in the trust funds by 2042, and then will have to delay benefit checks unless Congress has taken action to shore up the system.

3. U.S. Department of Housing and Urban Development, Estimated Median Family Incomes for FY 2004, PDR-2004-01, January 28, 2004.

4. The 18.4 percent tax rate would be for OASDI only. Hospital Insurance (Medicare Part A), now funded by a 2.9 percent payroll tax, faces even larger future deficits, rising to 9.98 percent of taxable payroll by 2080. The HI tax rate would have to rise to 12.88 percent to balance that system, bringing the combined OASDHI tax rate to 31.27 percent, with rounding (OASDI Trustees Report, Table VI.F2., p. 165). Supplementary Medical Insurance (SMI, Medicare Part B and the prescription drug benefit Part D) is funded 75 percent from general revenues and 25 percent from premiums and some state transfers for the drug benefit. It will also experience sharply higher costs over time. The general revenue transfer to SMI is equal to .9 percent of GDP in 2004 and will rise to 6.2 percent of GDP in 2080 (*2004*

Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Supplementary Medical Insurance Trust Funds, Table II.C15, p. 98, and Table II.C21, p. 107). That general revenue transfer to SMI is equal to nearly 10 percent of federal personal and corporate income taxes. In 2080, SMI will require about 60 percent of federal personal and corporate income taxes if those taxes remain at about 10 percent of GDP.

5.   We suggested substituting price indexing for wage indexing of the workers' earnings histories and the dollar amounts in the benefit formula that translates the earnings histories into initial benefits. Workers' earnings histories and the "bend points" (brackets) that determine how much of a person's average indexed monthly earnings (AIME) receive a 90 percent, 32 percent, or 15 percent "replacement factor" in setting his or her "primary insurance amount" or initial benefit are currently adjusted for nationwide wage growth each year. This has the effect of keeping replacement rates constant generation after generation, which keeps benefits growing as fast as wages. Switching to price indexing would have kept benefits rising in real terms, but not quite so fast (as real AIME growth spilled into brackets with lower replacement factors). This is one of many ways to alter the benefit formula to trim real benefit growth over time. The Rostenkowski and Pickle proposals used a different approach, adjusting the dollar amount of the bend points by the normal wage index less one percent for several decades.