IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

April 25, 2007 **Advisory No. 223**

2007 SOCIAL SECURITY TRUSTEES REPORT: EYE-POPPING BENEFIT SURGE DRIVING INSOLVENCY

The 2007 *Social Security Trustees Report*, released by the Social Security Administration on May 23, contains some surprising information 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 more than twice the real benefits that current retirees receive?
- will pay some future upper income working couples almost $125,000 a year in real benefits (2007 inflation-adjusted dollars)?
- will be giving most future retired couples more in Social Security benefits than the current median family income?
- will effectively require each working couple to support a retiree?

All of this is true, and it is revealed to the careful reader of the various tables in the *2007 OASDI Trustees Report*.

Most people only look at two bits of data in the *Trustees Report* – the year the system's benefit payments will exceed its tax revenues, creating cash flow deficits (2017), and when it will run out of spending authority by exhausting its trust funds (2041).[1]

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 2085.

Consider Table VI.F10. - Estimated Annual Scheduled Benefit Amounts for Retired Workers (*OASDI Report*, pp. 186-187.) The table (partially reproduced on the next page) shows the benefits that future generations are projected to receive after they retire in future years, 2007 through 2085. These benefits are displayed 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) 2007 dollars, and as a percent of pre-retirement income. They are shown here for people who work until normal retirement age (rising gradually from 65 to 66 and 67), and are also available in the Report for people who retire at a fixed age of 65 in the years ahead.

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 ultimately projected to be 55.3% of the wage in the year before retirement for low wage workers (earning 45% of the average wage), 41% for workers who earn the average wage all their lives, 34% for high earnings workers (160% of average wage) and 27.3% 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.

The OASDI Report projects real wages to increase by 135% between 2007 and 2085 (intermediate assumptions). A constant percent of a rising real wage means a rising real benefit. The average wage worker turning 65 in 2007 will get $16,361 upon first claiming benefits at his or her normal retirement age of 65 years and 10 months (which could be in 2007 or 2008). A similar worker turning 65 in 2030 will get $21,240 upon claiming benefits in 2032 at his normal retirement age of 67. A worker reaching age 65 in 2085 will get $38,363 upon claiming benefits at age 67 in 2087. The real benefit for the 2087 retiree will be 234% of that of the 2008 retiree. Those figures are for a single retiree. Add 50% for a spouse. If both spouses have worked at these wages, double the amounts.

A retired married professional couple, each having always earned the maximum covered wage, would collect between them a total of $50,426 upon claiming benefits at age 65 years and 10 months (in 2007 or 2008), $69,304 if claiming benefits at age 67 in 2032, and $124,928 upon starting benefits at age 67 in 2087. We are promising some future (2087) upper income retirees an annual benefit that is well over twice the current nationwide median family income ($55,832 in 2005)[2], and that would be in addition to any pension or savings that this upper income couple had accumulated. Rising real

Social Security Benefit Amounts for Retired Workers
Workers at Indicated Pre-Retirement Wage Levels
In Real Dollars and as Percent of Pre-Retirement Wages
Estimates for 2007 to 2085, 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 2007 $	Percent of Earnings	Real 2007 $	Percent of Earnings	Real 2007 $	Percent of Earnings	Real 2007 $	Percent of Earnings
2007	65:10	$9,921	56.0	$16,361	41.5	$21,640	34.6	$25,213	28.5
2010	66:00	9,941	53.4	16,394	39.6	21,732	32.8	25,944	27.0
2015	66:00	10,979	55.7	18,099	41.3	23,995	34.3	29,163	27.6
2020	66:02	11,618	55.9	19,143	41.4	25,386	34.3	30,999	27.5
2030	67:00	12,891	55.4	21,240	41.1	28,164	34.0	34,652	27.3
2040	67:00	14,339	55.2	23,627	41.0	31,327	33.9	38,527	27.2
2050	67:00	16,009	55.3	26,372	41.0	34,965	34.0	42,950	27.3
2060	67:00	17,816	55.4	29,353	41.1	38,913	34.0	47,799	27.3
2070	67:00	19,819	55.3	32,655	41.0	43,291	34.0	53,171	27.3
2080	67:00	22,070	55.3	36,360	41.0	48,202	34.0	59,203	27.3
2085	67:00	23,286	55.3	38,363	41.0	50,857	34.0	62,464	27.3

Source: 2007 OASDI Trustees Report, Table VI.F10, pp.186-187.

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 in 2005 to 2.2 by 2030 (when most of the baby boom generation will have retired) and to 1.9 by 2085. (See Table IV.B2. - Covered Workers and Beneficiaries, pp. 48-49, 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 replacement rate without having to raise the payroll tax rate. But with the ratio of workers to retirees falling by about 43 percent, either the replacement rate must fall by about 29 percent or the payroll tax rate must rise by about 43 percent, from 12.4% to 17.75% 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 up to nearly 18% of their wages to pay almost $125,000 a year in retirement benefits to an upper income couple?***[3]

Covered Workers Per OASDI Beneficiary
Intermediate Case

Year	Workers Per Beneficiary
2005	3.3
2010	3.2
2015	2.9
2020	2.6
2025	2.3
2030	2.2
2035	2.1
2040	2.1
2045	2.1
2050	2.0
2055	2.0
2060	2.0
2065	2.0
2070	1.9
2075	1.9
2080	1.9
2085	1.9

Source: 2007 OASDI Trustees Report, Table IV.B2., pp. 48-49.

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

These tables make an important point. Since real 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 benefits, so that they no longer grow quite as fast as wages. The trimming could be done 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 fact, 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.

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 deficit in 2081 by about 25 percent, and delay trust fund exhaustion by 6 years. (Table VI.D4. - Sensitivity to Varying Real-Wage Assumptions, p. 153.) Real wages might rise that much faster, at least for two or three decades, if the multiple layers of tax imposed on saving and investment under the current income tax system were eliminated, boosting the investment and productivity gains that raise real wages. This suggests that fundamental tax reform would be a good way to address part of the pending retirement problem. The reduction in the deficits from faster wage growth would be even larger if the benefit formula were altered so that real benefits would not grow in lock step with real wages.

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 deficit in 2081 by nearly 9.4 percent, and would delay trust fund exhaustion for 2 years. (Table VI.D3. - Sensitivity to Varying Net Immigration Assumptions, p. 152.) 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.

Stephen J. Entin
President & Executive Director

Endnotes

1. The OASDI program's outlays will exceed its tax revenue in 2017. Thereafter, OASDI will have to use some of the interest payments that the trust funds receive from the Treasury to cover part of its outlays, instead of just 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 another 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.) About a decade later, 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, the Treasury will similarly have to redeem the 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 2041, and then will have to delay benefit checks unless Congress takes action to shore up the system.

2. Accessed at http://factfinder.census.gov/servlet/ADPTable?_bm=y&-qr_name=ACS_2005_EST_G00_DP3&-goe_id=D&-ds_namne=D&-_lang=en.

3. That tax rate would be for OASDI only. Hospital Insurance (Medicare Part A), also funded by the payroll tax, faces even larger future deficits, rising to 8.52% of taxable payroll by 2085 (*2007 OASDI Trustees Report*, Table VI.F2, p. 167). Its tax rate, currently 2.9%, would have to rise to 11.42% to balance that system. Supplementary Medical Insurance (Medicare Part B (physicians services), funded 75% from general revenues and 25% from premiums, and Medicare Part D (prescription drugs), funded 82% from general revenues, 7% from premiums, and 11% from state payments), faces sharply higher costs, and will be a drain on federal general revenues. SMI currently takes nearly 12 percent of federal personal and corporate income taxes. In 2080, it will take 41.3 percent of federal personal and corporate income taxes (*2007 HI/SMI Trustees Report*, Table III.C4, p. 81).

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.