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COLAS NOT THE CAUSE OF SOCIAL SECURITY DEFICITS

Cost of living adjustments (COLAs) that are slightly overstated by the much maligned Consumer Price Index are not the source of Social Security's looming deficits, and fixing the CPI and the COLAs will not save Social Security from impending collapse.

There are two real culprits leading to the projected Social Security deficits. One is an adverse demographic shift as the baby boom retires, life expectancy rises, and the population ages.

There are two real culprits leading to the projected Social Security deficits. One is an adverse demographic shift as the baby boom retires, life expectancy rises, and the population ages. Currently there are 3.3 workers paying into the system for each retiree drawing benefits. That ratio will fall to 3 workers per retiree by 2010, 2.0 workers per retiree by 2030, and to 1.8 workers per retiree by 2070. The decline in the ratio stems in part from the impending retirement of the post-World War II baby boom generation, which will be followed into the work force by the baby bust generation.

The other source of the deficits is the Social Security initial benefit formula.... [P]er capita real benefits at the normal retirement age are ... projected to roughly double under current benefit formula rules between 1997 and 2075.

Exacerbating the population shift is a continuing increase in life expectancy. According to the 1997 Social Security Trustees Report, life expectancy at age 65 in 1997 is 15.6 years for men and 19.2 years for women. The Report projects those figure to reach 17.5 and 20.9 years, respectively, by 2040, and 18.8 and 22.3 years, respectively, by 2075. A larger group of retirees will live and draw benefits 16 to 20 percent longer than they do today.

The other source of the deficits is the Social Security initial benefit formula. The initial benefit formula sets the benefit check that a retiree receives when he or she begins to draw benefits. The benefit is based on a worker's earnings history — the income on which he or she paid social security taxes over the years. Those yearly earnings are adjusted for wage growth, averaged, and subjected to a complex formula that determines each person's initial monthly benefit check. The initial benefit formula is independent of the subsequent cost of living adjustments that protect the initial benefit from subsequent inflation. Consequently, changes in the COLAs have little impact on the initial benefits that future generations will receive. (See note.)

The initial benefit formula is designed to keep benefits growing in line with income, generation after generation, no matter how much income grows over time. The "replacement rates" (initial benefits upon retirement as a percent of pre-retirement income) are kept constant across all future generations — at about 56% for low wage workers, 42% for average wage workers, and 27% for upper income workers. (See table.)

Per capita real income is projected to roughly double over the next 75 years. Consequently, per

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capita *real* benefits at the normal retirement age are also projected to roughly *double* under current benefit formula rules between 1997 and 2075. A single professional worker retiring in 1997 could start out with a benefit of as much as $15,955; a professional married couple with as much as $31,700. A similar worker retiring in 2075 could get an initial benefit of over $33,850, and a couple over $67,700, in today's money if real wages rise as projected. (See Table.)

People who have tried repeatedly to patch up the system are always surprised that it keeps slipping back into deficit, but there is no mystery as to why. It is not possible to pay rising real benefits for a rising number of years of retirement with a declining number of workers per beneficiary without substantial tax rate increases. Furthermore, every effort to patch up the system has reinforced the adverse demographic trends that render the system unrepairable. Each payroll tax increase has discouraged employment, saving, and income. People are young before they are old. It makes no sense to lower their after-tax incomes, employment opportunities, and ability to save while they are of working age in order to give them higher transfer payments after they retire.

Instead of attacking COLAs of current retirees, it would make more sense to slow the growth of real initial benefits for future retirees by amending the benefit formula and raising the normal retirement age. These changes could save three times the money as trimming COLA's 1% per year. (The ultimate reform, privatization, would save even more money while leaving future workers and retirees better off.)

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Estimated Pre-retirement Income and Real Benefit Amounts of Retired Single Workers Upon Retirement at Normal Retirement Age* With Various Pre-retirement Earnings Levels** Based on Intermediate Assumptions

	Benefits, constant 1997 Dollars			Percent of earnings			Pre-retirement income, 1997 $s		
Year Attaining Age 65	Low Earnings	Average Earnings	Maximum Earnings	Low Earnings	Average Earnings	Maximum Earnings	Low Earnings	Average Earnings	Maximum Earnings
1997	6,810	11,226	15,955	58.8	43.6	25.4	11,582	25,748	62,815
2010	7,277	12,031	18,807	56.7	42.2	27.2	12,834	28,509	69,143
2040	9,479	15,693	25,025	56.4	42.1	27.7	16,807	37,276	90,343
2075	12,837	21,250	33,857	56.5	42.1	27.6	22,720	50,475	122,670

* Normal retirement age at which full benefits are payable is currently 65. It is scheduled to rise to 66 and 67 in stages. Line 2010 shows benefits for individual retiring at age 66 in 2011; for 2040 and 2075, retiring two years later at age 67.
** Low earnings equal 45 percent of average earnings. Average earnings assume worker earned national average covered earnings each year of working life. Maximum earnings assume worker earned the SSA contribution and benefit base (maximum covered earnings) each year of working life. Source: 1997 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds, Table III.B5.

Note: The CPI has a small impact on initial benefits if a worker delays claiming benefits past age 62, but the effect on lifetime benefits is largely offset because the worker will draw benefits for fewer years and receive fewer COLAs.

Note: Nothing written 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 Congress.