The Wrong Way to Fix Social Security

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The Bush Administration has not yet put forth a specific plan to reform Social Security. Every indication, however, suggests it favors the leading plan developed by the President's Commission to Strengthen Social Security. Unfortunately, this plan, often referred to as "Model 2," is seriously flawed. It manages both to increase government debt for the next 60 years *and* to reduce benefits substantially.

Under the Commission plan, Social Security would wither away over time. According to the Congressional Budget Office, for example, young workers today in the middle of the income distribution would experience a reduction in benefits of almost 40 percent, or about $9,000 a year, even including the payout from the individual accounts included in the plan. The result of these excessive and unwarranted benefit reductions is that Social Security would increasingly fail to provide an adequate core tier of retirement income upon which to build other retirement saving.

Despite this substantial reduction in benefits, Model 2 involves a considerable increase in public debt over several decades. The troubling combination of large benefit reductions and large increases in debt is not limited to the plan from the President's Commission. Instead, it is inherent in the broader approach that the Administration appears to support. The President appears to be opposed to devoting additional revenue to Social Security. The absence of such additional dedicated revenue forces large benefit reductions to close the deficit. Then the diversion of existing payroll tax revenue into individual accounts, again without any new dedicated revenue devoted to Social Security, triggers significant borrowing.

[1] The views expressed here are those of the author alone. This testimony draws upon joint work with Peter Diamond and Robert Greenstein.

Although this problematic combination of large benefit reductions and large increases in debt would be present in almost any plan consistent with the Administration's principles, it is useful to see how it plays out in the specific model provided by the President's Commission.

Model 2 includes two key components: a change in how Social Security benefits are determined and the diversion of payroll revenue into individual accounts.

Step 1: "Price indexation"

Model 2 changes the determination of individual benefits to incorporate what is commonly -- but somewhat misleadingly -- referred to as "price indexing."[2] The change may sound innocuous, but it would dramatically reduce benefits over time. For example, had this rule been fully in effect by 1983, at the time of the last major reform to Social Security, benefits for newly eligible retirees and disabled workers now would be almost 20 percent lower and continuing to decline relative to current law. These benefit reductions would apply regardless of whether a worker elected to participate in the individual accounts under the Commission plan.

Under current law, benefits for new retirees roughly keep pace with wage growth.[3] Successive generations of retirees thus receive higher benefits because they had

[2] This approach has also been employed in legislation introduced by Senator Lindsey Graham. As noted below, it is more accurately called "real wage growth negating" than "price indexing," since it removes the impact of real wage growth on benefit levels, rather than incorporating a price index directly into the benefit formula.

[3] Initial retirement benefits are based on a worker's average indexed monthly earnings. Average indexed monthly earnings, in turn, are determined by taking earnings in previous years and scaling them up by subsequent national average wage growth. The wage indexing occurs through the year in which a worker turns 60, with later wages used on a nominal basis (unindexed). The initial benefit level is thus indexed to wage growth through age 60. After initial benefit determination, benefit increases are indexed to price growth. Price indexing of benefits begins after the year in which a worker turns 62. Thus there is a gap with no indexing to either wages or prices, which should be corrected -- and could be addressed on a revenue-neutral basis if desired. The formula relating full benefits (the so-called Primary Insurance Amount) to earnings is also indexed to average earnings. In 2005, the Primary Insurance Amount is equal to 90 percent of the first $627 of AIME; 32 percent of AIME over $627 and through $3,779; and 15 percent

higher earnings — and paid higher payroll taxes — during their careers. This feature of the Social Security system makes sense, since a goal of Social Security is to ensure that a worker's income does not drop too precipitously when the worker retires and ceases to have earnings. A focus on how much of previous earnings are replaced by benefits, which is called the "replacement rate," recognizes the real-world phenomenon by which families, having become accustomed to a given level of consumption, experience difficult adjustment problems with substantial declines in income during retirement.

Under what is called price indexing, by contrast, initial benefit levels upon retirement would increasingly lag behind wage growth. In particular, real benefit levels would be constant over time, rather than increasing in line with real wages. Since real wage growth is positive on average, the change would reduce initial benefit levels and the size of the reduction would increase over time.[4]

Under this proposal, if average real wages were ten percent higher after ten years, the roughly ten percent benefit growth to keep pace with this wage growth would simply be removed. The provision thus is more accurately described as "real wage growth negating" than as "price indexing," since it simply cancels the benefit increases from real wage growth.[5]

Several commentators have underscored the troubling consequences that would result from "price indexing." Edward Gramlich, a leading economist who chaired the Advisory Commission on Social Security in the mid-1990s and who is now a governor of the Federal Reserve System, has been quoted as saying that if this methodology had been adopted when Social Security was created, [retirees] "would be living today at 1940

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of AIME over $3,779. The "bend points" at which the 90, 32, and 15 percent factors apply are indexed to wage growth.

[4] The 2004 Trustees Report projects long-run growth of prices of 3.0 percent per year and long-run growth of taxable wages of 4.1 percent per year, resulting in a growth of real wages of 1.1 percent per year. But real wage growth may turn out to be larger or smaller than this amount.

[5] More precisely, the proposal would multiply the 90 percent, 32 percent and 15 percent factors used to compute the Primary Insurance Amount by the ratio of cumulative price growth to cumulative wage growth between the start date and the year in which a worker becomes entitled to claim benefits. It is thus important to note that wage indexing would still be part of the determination of benefits.

living standards."[6] An earlier analysis of the proposal underscored that: "This is like saying retirees who could afford indoor plumbing when they were working should, in retirement, not be able to afford indoor plumbing because their parents' generation could not afford it."[7] Even some leading proponents of the Administration's broad approach have acknowledged this point. For example, John Goodman, president of the National Center for Policy Analysis, recently commented about the price-indexing proposal: "What people are forgetting is why the system is there in the first place. The reason is that people don't want to reach retirement age and have their standard of living cut in half."[8]

Two implications of reducing benefits to cancel out real wage growth are immediately obvious. First, the longer the "price indexing" provision stays in effect, the larger the benefit cuts, assuming ongoing real wage gains. Second, the more rapid real wage growth, the larger the benefit cuts.[9]

Table 1: Effect of "price indexing/real wage growth negating" provision on benefits

Age when implemented	Change from scheduled benefits assuming real wage growth of:	
	1 percent per year	*1.5 percent per year*
55	-0.0%	-0.0%
45	-9.6%	-14.0%
35	-18.2%	-26.1%
25	-26.0%	-36.5%
15	-33.1%	-45.4%
5	-39.5%	-53.0%
0	-42.5%	-56.4%

Note: Calculated as $1-(0.99^{55-age})$ and $1-(0.985^{55-age})$.

[6] Greg Ip, "Social Security: Five Burning Questions," Wall Street Journal Online, December 19, 2004.

[7] "Price-Indexing the Social Security Benefit Formula Is a Substantial Benefit Cut," prepared by the minority staff of the Social Security Subcommittee, House Committee on Ways and Means, November 30, 2001.

[8] Cited in Edmund L. Andrews, "Most G.O.P. Plans to Remake Social Security Involve Deep Cuts to Tomorrow's Retirees," *New York Times*, December 13, 2004.

[9] This second implication may not be widely understood: The proposal reduces benefits *more* if real wage growth is more rapid than expected. Yet if real wage growth is more rapid, the actuarial deficit over 75 years in the absence of this provision would be smaller, not larger. The use of real wage negating is thus even more troubling than simply reducing benefits based on *expected* real wage growth today. The larger actual real wage growth turns out to be, the smaller the need for benefit reductions -- but the larger those reductions actually are under the real wage negating approach. In other words, the approach introduces variation in benefit reductions relative to scheduled benefits that are larger the less the financial need of Social Security for such reductions.

Table 1 shows the size of benefit cuts under "price indexing," relative to the benefits provided under the current benefit formula, assuming that real wage growth is either 1 percent per year or 1.5 percent per year.[10] A worker who is 35 years old when the change is enacted would have benefits reduced by 18.2 percent if real wage growth averages 1 percent annually. The benefit reduction for the 35-year-old is much larger, 26.1 percent, if real wage growth turns out to be 1.5 percent annually. The future benefit level for a newborn at the time of legislation would be reduced by 42.5 percent relative to the scheduled benefit level with 1 percent real wage growth per year and 56.4 percent with 1.5 percent real wage growth per year.[11] The replacement rates from Social Security would be reduced by corresponding percentages.

The bottom line is that, because of steep benefits reductions under the proposal, the role of the Social Security system in allowing the elderly to maintain their standard of living after retirement would decline sharply over time.

Step 2: Divert revenue into individual accounts and reduce subsequent benefits

The second part of the Commission plan would allow workers to divert payroll taxes into individual accounts. The diversion of revenue would be paid for in part by *another* reduction in Social Security benefits for those workers who participate in the accounts, on top of the universal benefit reduction that "price indexing" would impose. Many people initially hearing about the Commission plan do not realize that their traditional benefits from Social Security would be reduced to offset part of the cost of the revenue diverted into the account.

[10] The figures assume that the new system does not apply to workers age 55 and over at the time legislation is enacted, so that the reductions in benefits would be phased in starting with workers who were 54 when the legislation was enacted. For each additional year that a worker is younger than 55, the benefit formula is reduced by an additional amount equal to the percentage real wage growth of another year.

[11] Within the traditional 75-year horizon, the largest reduction in retirement benefits would occur for a worker reaching age 62 in 75 years. Of course, such a worker is not yet alive. For such a future worker, the reduction would be almost one-half with 1 percent real growth and nearly two-thirds with 1.5 percent growth.

In particular, if a worker chose to participate in the individual account system, a portion of his or her payroll taxes would be diverted into an individual account. These amounts would accumulate in the account during the worker's career and be available to the worker upon retirement. But since the revenue diverted to this account would reduce the financing available to the traditional Social Security system, a "liability account" would also be created. The liability account would be designed to track the debt owed back to Social Security because of the diverted funds. Upon retirement, the debt would be repaid by reducing the worker's traditional Social Security benefit, regardless of the investment returns that have actually been earned on the account. These reductions would be in addition to the traditional benefit changes described earlier.

Since the additional reduction in benefits for those participating in the accounts would not occur for many decades, however, the diversion of revenue into private accounts would pose a significant financing problem: It would cause Social Security to start running short of what it needs to pay benefits almost immediately. The Commission plan, along with many other similar plans, would address this newly created shortfall through large amounts of new government borrowing, which, in turn, would further swell budget deficits.

The net result would thus be both substantial reductions in Social Security benefits and a significant increase in debt for several decades.

The overall implications for benefits

The combined effect on future benefits from the plan proposed by the President's Commission is stunning. For example, the Congressional Budget Office has projected that under the current benefit formula, the median Social Security benefit for workers born in the 1990s whose earnings place them in the middle of the income spectrum and who claim benefits at age 65 will be $1,942 per month. That benefit level replaces 39.5 percent of previous wages.

Under the Commission plan, by contrast, these workers would receive only $1,208 per month, *including* the payouts they would receive from their individual accounts. (In computing these figures, CBO adjusts its projections of the payout from the individual account for the greater risks of stocks compared to bonds.) Replacement rates would be similarly reduced, to just 25 percent of previous wages for workers in this generation.

Table 2: Initial benefit levels at age 65 for middle household earnings quintile under current law and under Model 2 (including individual accounts)

Decade born	Scheduled benefits		"Payable" benefits*		Model 2, with individual accounts**	
	Monthly benefit, 2004 dollars	Replacement rate	Monthly benefit, 2004 dollars	Replacement rate	Monthly benefit, 2004 dollars	Replacement rate
1940	1,242	42.9	1,242	42.9	1,242	42.9
1950	1,267	43.0	1,275	43.0	1,175	39.9
1960	1,292	41.0	1,292	41.0	1,092	34.8
1970	1,475	40.5	1,475	40.5	1,133	30.9
1980	1,708	39.8	1,642	38.7	1,192	27.4
1990	1,942	39.5	1,508	30.8	1,208	24.6
2000	2,200	39.6	1,658	29.8	1,217	21.7

Source: Congressional Budget Office, "Long-Term Analysis of Plan 2 of the President's Commission to Strengthen Social Security," updated September 2004

* Benefits reduced to match incoming revenue after trust fund is exhausted.

**CBO adjusts its projections of the payout from individual accounts to account for the greater risks of stocks compared to bonds.

For these workers, benefits under the Commission plan are thus 38 percent, or almost $9,000 a year, less than these workers would receive under the current benefit formula (Table 3). In fact, they are 20 percent, or more than $3,500 a year, less than what CBO estimates the system could afford to pay even with no reform, if benefits were simply reduced to match incoming payroll revenue after the trust fund is exhausted (so-called "payable benefits").

Table 3 shows that the benefit reductions are substantial, and continue to grow over time, regardless of whether comparisons are undertaken with regard to the current benefit formula ("scheduled benefits") or to the benefits that could be paid after the trust fund is exhausted and assuming no additional revenue is devoted to Social Security

("payable benefits"). Again, these benefit comparisons *include* the payouts from the individual accounts as scored by CBO.

Table 3: Benefit reductions at age 65 for middle household earnings quintile, including individual account

Decade born	Compared to scheduled benefits		Compared to "payable" benefits	
	Percentage change	Change in annual benefit level (2004 dollars)	Percentage change	Change in annual benefit level (2004 dollars)
1940	0%	0	0%	0
1950	-7%	-1,100	-8%	-1,200
1960	-15%	-2,400	-15%	-2,400
1970	-23%	-4,100	-23%	-4,100
1980	-30%	-6,200	-27%	-5,400
1990	-38%	-8,800	-20%	-3,600
2000	-45%	-11,800	-27%	-5,300

Source: Congressional Budget Office, "Long-Term Analysis of Plan 2 of the President's Commission to Strengthen Social Security," updated September 2004

*CBO adjusts its projections of the payout from individual accounts to account for the greater risks of stocks compared to bonds.

Conclusions

The Commission's plan shows clearly the implications of trying to close the long-term Social Security actuarial deficit solely by benefit reductions. Although it incorporates only one particular pattern of how benefits could be reduced for workers born in different years, it illustrates the broader implications of failing to dedicate any additional revenue to Social Security. Not surprisingly, such an approach involves dramatic benefit reductions, including for those beneficiaries with little or no ability to draw upon an individual account, such as the disabled and young survivors.

To be sure, Social Security needs some adjustments to remain financially healthy for the long term. The outsized benefit reductions incorporated into the principal plan put forward by the President's Commission, however, are neither desirable nor necessary.[12]

[12] For one plan that achieves sustainable solvency without the severe benefit reductions included in Model 2, see Peter A. Diamond, and Peter R. Orszag, *Saving Social Security: A Balanced Approach* (Washington: Brookings Institution Press, 2004).