



Social Security for All Ages

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Summary

For nearly 70 years, Social Security has been the bedrock of income security for nearly all Americans, providing benefits to retirees, those with disabilities, and the survivors of retired and deceased workers. The program has never missed a benefits payment in its history. However, the program is threatened by proposals to divert a portion of payroll contributions from the Social Security Trust Fund into private accounts and cut benefits.

This brief draws upon a report released earlier by the Alliance for Retired Americans Educational Fund, *Social Security Under Attack*, to highlight how the program works, the protections that it provides, key points about the effects of privatization and how minor adjustments will provide for promised benefits over the next 75 years.

The Benefit Cuts and Privatization Proposals

President Bush is making privatization of Social Security his top domestic priority. His proposal would divert some of the funds that normally go into the Social Security Trust Fund into private investment accounts. According to an internal White House memo, the President also plans to cut benefits by

Social Security At-A-Glance

In 2005, almost 48 million people, or 1 out of every 6 Americans, will receive Social Security benefits.

Retired Workers	30 million	\$955 average monthly benefit
Dependents	3.1 million	
Disabled Workers	6.2 million	\$894 average monthly benefit
Dependents	1.8 million	
Survivors	6.7 million	\$920 average monthly benefit

Source: Social Security Administration

President Bush's Commission to Strengthen Social Security

In May 2001, President Bush appointed 16 people to his Commission to Strengthen Social Security, all of whom publicly supported private individual accounts. In December 2001, the commission released its final report, which outlined three options for reform. All three options included diversion of payroll taxes from the Social Security Trust Fund into private accounts—between one to four percentage points. None of the three options addressed Social Security's long-term solvency.

Option 2 of the Social Security Commission's report is frequently cited as the likely model for the President's plan.

The basics of Option 2 are:

- Four percent of taxable payroll contributions made to Social Security would be diverted to private accounts;
- Initial benefit calculation would be indexed to prices instead of wages;
- Cuts in guaranteed benefits, which would apply to all workers whether or not they have private accounts;
- Additional benefit cuts for workers with private accounts;
- Workers could not access account until retirement age; and
- General revenue transfers would be required from 2021-2054 in order to pay benefits.

changing the base for initial benefits from a wage-indexed system to a consumer price-indexed payment.¹ Although privatization proposals have circulated for over 20 years, the anticipated model in the current debate comes from Option 2 of the President's 2001 Social Security Commission report. (See box.)

Benefit Cuts

Initial Social Security benefits are calculated to reflect the standard of living a person enjoys based on earnings. When benefits are calculated at age 65, or normal retirement age, based on earnings over a lifetime, the salary earned in prior years is adjusted upward to reflect wage growth. As a result, each succeeding generation of workers enjoys higher Social Security benefits that reflect the higher average wages that generation has earned.

The price-indexing proposal would replace the wage-based formula with one based on the rise in consumer prices, essentially the inflation rate. Wages generally rise faster than price inflation, thus a price-indexing formula would result in lower salary adjustments and benefits at retirement.

Over time, the benefit would be lower for each generation of new retirees. For someone retiring in 2032, traditional benefits that are price-indexed would be cut by 18 percent. For someone retiring in 2066, the benefit would be reduced by 41 percent.² (See Table 1.)

The benefit cuts would apply to all beneficiaries whether or not they had a private account. Workers who choose private accounts will likely have additional benefit cuts.

An alternative proposal would continue wage indexing of benefits for low earners, impose price indexing of benefits for high earners and use a mix of wage indexing and price indexing for average wage earners. However, this so-called “progressive indexing” would impose substantial benefit reductions on average wage workers and make the system unattractive to high earners. For an average wage earner who retires in 2075, the benefit reduction would be 28 percent or \$7,629 in today’s dollars.³

Year turning age 65	Traditional Benefits (for those who do not opt for private accounts)
2012	-0.9
2032	-18.2
2052	-32.5
2066	-41.0

Private Accounts

Currently, workers contribute 6.2 percent of their taxable earnings to the Social Security Trust Funds, employers contribute an equal amount. Thus, 12.4 percent of taxable earnings up to \$90,000 go to the Social Security Trust Funds. President Bush proposes to allow workers younger than age 55 to divert 4 percent, or one-third of Social Security contributions, into a private investment account. The limit would be \$1,000 a year initially, rising \$100 per year afterwards.

Private accounts will be very costly for both the Social Security program and those choosing the accounts because of offsets. Under the Bush plan, workers age 44 to 59 would be eligible for the program in 2009, with those age 32 to 60 added in 2010, and younger workers added in 2011. With this scenario, the transition costs increasing the government’s total debt would be \$1.4 trillion over the first 10 years of the plan and \$4.9 trillion over the first 20 years.⁴

A worker choosing a private account option would owe a “debt” to the Social Security Trust Fund to offset the funds that had been diverted to the private accounts plus interest. However, the funds paid back to the Trust Fund would be less than the amount that the Trust Fund would lose, thus aggravating the financing gap of Social Security.⁵

When workers retire, the Bush plan would subtract from their traditional Social Security benefit all of the money deposited in their private accounts, plus 3 percent interest above inflation. The offset, or “clawback,” equals the amount the White House assumes those deposits would have earned in Treasury bonds if they had gone into Social Security. In effect, the accounts work as a loan from the government to be paid back upon retirement at an inflation-adjusted 3 percent interest rate.

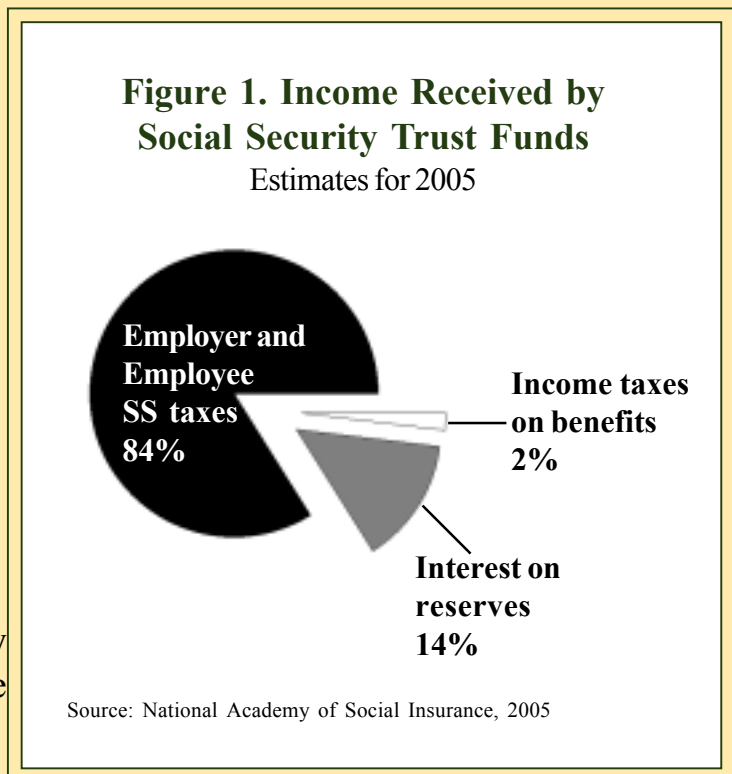
In addition, the accounts will be subject to the volatility of the stock market and high administrative costs. An examination of foreign examples reveals that the World Bank acknowledges that in Chile one-half of the pension contributions of the average worker who retired in 2000 went to management fees. In Great Britain, such costs eat up 20 to 30 percent of contributions.⁶ In contrast, the Social Security Administration spends just 1 percent of income for administrative costs.

Who Wins With Private Accounts?

The investment industry would acquire millions of accounts for which they could charge substantial fees for administering them. One calculation of the financial community's gain in fees is \$940 billion, amounting to one-quarter of the currently anticipated revenue of the entire financial sector for the next 75 years. Wall Street's own association, the Securities Industry Association, acknowledges windfalls of \$39 billion to \$279 billion or more over the next 75 years.⁷ Insurance companies would gain from the sale of annuities as those who have private accounts would be required to purchase annuities at retirement. In today's insurance market,

Understanding the Trust Funds

Each year, the government reports the amount of money in the Old Age, Survivors, and Disability Insurance Trust Funds, the amount added or redeemed in a given year, as well as the interest earned. Over the last 20 years, the Social Security Administration has been putting aside ever larger surpluses to provide for the pending baby boomers' retirements. As a result of interest earnings, the Social Security actuaries project fund assets will reach \$4.7 trillion in 2017, increasing by another \$1.3 trillion for the nine years after that.⁸ Between then and 2041, Social Security will have to supplement its income by drawing down on its reserves; but these are projected to be sufficient to pay full benefits until 2041. After 2041, the system will be able to pay 74 percent of the promised benefits. The Congressional Budget Office uses more optimistic assumptions and projects that the trust funds can pay full benefits until 2052 and 78 percent of benefits after that.⁹



In 2005, the Social Security Trust Funds will receive income of \$690 billion and pay out \$527 billion, leaving a surplus of \$163 billion. Employer and employee taxes account for 84 percent of the income; interest on the reserves, 14 percent; and income taxes on benefits, 2 percent. (See Figure 1.) Almost all the payments will be for benefits with less than one percent spent on administration. The surplus is invested in interest-bearing U.S. government securities. By the end of 2005, the trust funds reserves are estimated to be \$1.8 billion.¹⁰

The Treasury bonds held by the Trust Funds are every bit as real as the bonds held by banks, corporations, or individuals. Throughout the history of the United States, the federal government always paid off its bonds which are backed by the full faith and credit of the federal government.

annuities account for only 5 percent of the industry's revenues. Current stockholders, mainly wealthy individuals, would benefit from the President's plan because privatization would raise the price of existing stock.

The Inheritance Myth

President Bush asserts that his plan would allow investors to pass on their accounts to their heirs when they die. What he does not say is that the Social Security survivorship benefit paid to the minor children and spouses of the deceased worker would be substantially cut by his formula change in evaluating earnings. If a worker dies at a young age, no amount of inheritance would offset the loss of benefits resulting from the deep cuts in benefits and the potential offsets for diverting funds to a private account.


Moreover, the President indicates that when they retire most individuals would have to transfer their invested funds into an annuity. Thus, there would be no account funds for an inheritance, except for the provisions of the annuity. Under present law, a retiree's spouse at full retirement age receives 100 percent of the worker's Social Security benefit; but under the President's plan, the benefit would be reduced by both the benefit cut and by the funds diverted to a private account. These cuts would dwarf any inheritance incorporated into an annuity.

A Contrived Crisis


President Bush speaks about an \$11 trillion shortfall that threatens Social Security creating an immediate crisis. However, this dire prediction is based upon a projection first made by the trustees in the spring of 2003 that extends the normal 75-year projection period into infinity. Using the more normal actuarial projection of 75 years, the gap shrinks to \$4 trillion in net present value (1.92 percent of taxable payroll) or to \$2 trillion (1.0 percent of taxable payroll) according to the Congressional Budget Office.¹¹

The American Academy of Actuaries objected to the change in estimation horizons and wrote to the trustees that infinite projections provide "little if any useful information about the program's long-range finances" and are "likely to mislead anyone lacking technical expertise... into believing that the program is in far worse financial condition than is actually indicated."¹²

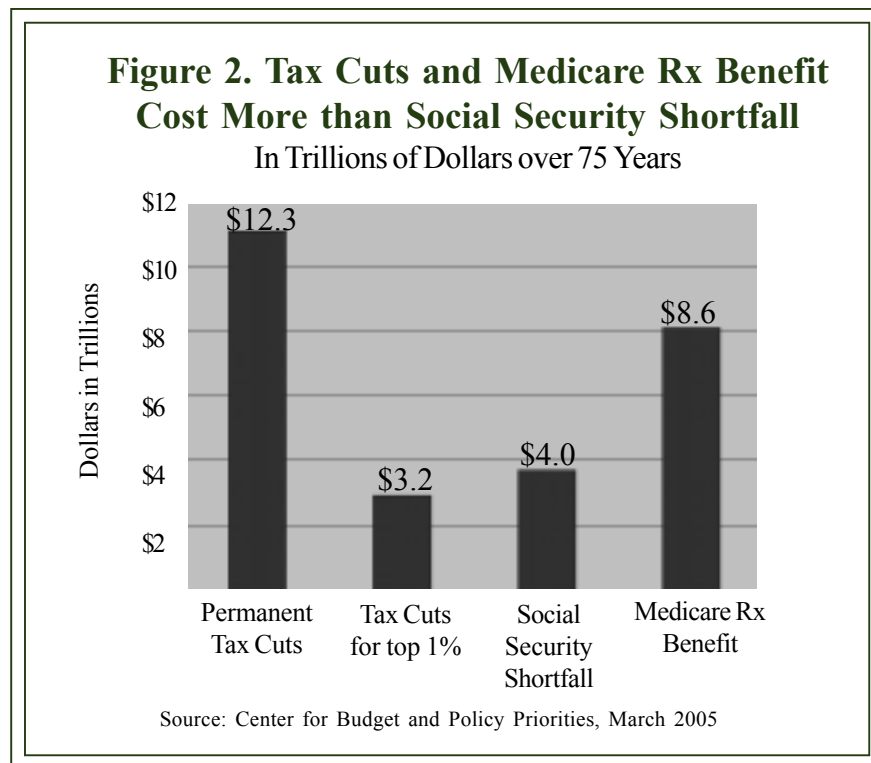
The \$4 trillion shortfall in Social Security pales in comparison to the costs to the Treasury of the tax cuts enacted since 2001. Over the next 75 years, the President's tax cuts, if made permanent, will cost \$12.3 trillion, triple Social Security's gap. The shortfall in the Medicare program due to escalating health care costs and the new prescription



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drug benefit is twice the size of the Social Security shortfall. Tax cuts for the top 1 percent alone will cost \$3.2 trillion, if made permanent.¹³ (See Figure 2.)



Better Solutions

There is no crisis with the Social Security system as the currently projected shortfall occurs after 2041 or 2052. Moreover, these projected shortfalls can be met in a variety of ways. Some favor an increase in taxes such as a rise to 7.1 percent on employer and worker contributions to Social Security to meet any projected short-fall for 75 years. Others favor a cut in benefits. Some suggest raising the retirement age further – perhaps to age 70. Others recommend that there should be increased incentives for workers to delay retirement, thus reducing the long-term costs of the system. Still others suggest that the Social Security surplus be invested in stocks, rather than in government bonds.

However, the Alliance for Retired Americans has repeatedly called for a change that would raise or remove the current \$90,000 cap on taxable earnings. This would increase the contributions of the 6 percent of earners who are paid more than the capped amount. AFL-CIO President John Sweeney has also suggested that, rather than repealing the inheritance tax after 2009 as President Bush proposes, the inheritance tax on estates, above \$3.5 million for an individual or \$7 million for a couple, be directed into the Social Security Trust Funds. Maintaining the tax would affect one-half of one percent of all estates.

Raising the cap and dedicating the estate tax to Social Security would meet over two-thirds of the projected shortfall, and would improve the progressivism of the payroll tax. Meeting most of the projected shortfall would allow full promised benefits to be paid over the forecasting period of 75 years to retirees, disabled beneficiaries, and survivors.

Conclusion

The Social Security debate raises fundamental questions about what kind of society American strives for in the future. Social Security today guarantees that everyone who works, and their families, can live decently in retirement or in disability. Furthermore, survivors of deceased workers are protected.

The President proposes abandoning this guarantee and substituting it with private accounts, which would be subject to the vagaries of the stock market. This effort, if successful, would shift the risks of the economy from the nation as a whole to the individual and jeopardize the one guaranteed source of income for all Americans.

Social Security is a bridge that spans class, race, income and generations. The program is under the most serious assault in its 70-year history. If Social Security is to survive as the program that provides guaranteed, risk-free, inflation-adjusted lifetime protection, then the fight for the program's survival must be joined by everyone—workers, retirees, those with disabilities, families and survivors, and especially young people—because everyone has a stake in the outcome.

Endnotes

¹ Internal White House memo, "Some Thoughts on Social Security" from Peter Wehner, Director of White House Strategic Initiatives. January 3, 2005.

² Report of the President's Commission to Strengthen Social Security. December 2001; Center on Budget and Policy Priorities and the Century Foundation. "Reducing Benefits and Subsidizing Individual Accounts: An Analysis of the Plans Proposed by the President's Commission to Strengthen Social Security." 2002.

³ Center on Budget and Policy Priorities. "An Analysis of Using 'Progressive Price Indexing' to Set Social Security Benefits." March 21, 2005.

⁴ Center on Budget and Policy Priorities. "What the New Trustees' Report Shows About Social Security." March 23, 2005.

⁵ Center on Budget and Policy Priorities, 2002.

⁶ The Century Foundation. "Twelve Reasons Why Privatization is a Bad Idea." December 2004; Blake, David. "The United Kingdom: Examining the Switch from Low Public Pensions to High-Cost Private Pensions." Social Security Pension Reform in Europe. University of Chicago Press, 2002.

⁷ Goolsbee, Austan. "The Fees of Privatization on Financial Managers." 2004; United Press International. "Study: Privatized Social Security Won't Help Brokers." December 10, 2004.

⁸ U.S. Social Security Administration. "Status of the Social Security and Medicare Programs: A Summary of the 2005 Annual Reports."

⁹ Congressional Budget Office. "Updated Long-Term Projections for Social Security." March 2005.

¹⁰ Social Security Administration. *op cit*.

¹¹ Social Security Administration and Congressional Budget Office. *op cit*.

¹² Letter from the American Academy of Actuaries to the Trustees of the Social Security System. December 19, 2003.

¹³ Center on Budget and Policy Priorities. 2005.

Social Security Is a Valuable Investment

Social Security is worth a ...



Retirement policy
of \$250,000



Disability policy of
\$353,000



Life insurance
policy of
\$403,000

Source: National Academy of Social Insurance

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