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SOCIAL SECURITY COMMISSION PLANS WOULD ENTAIL SUBSTANTIAL BENEFIT REDUCTIONS AND LARGE SUBSIDIES FOR PRIVATE ACCOUNTS

New Study Analyzes Implications of Commission Plans for Retirement Benefits, Social Security Financing, and the Budget

The proposals that President Bush's Social Security Commission issued in December would substantially reduce benefits for future retirees and the disabled while requiring multi-trillion dollar transfers from the rest of the budget to finance private retirement accounts, according to a major new study co-authored by the incoming president of the American Economic Association and a Brookings Institution expert on the economics of retirement. The study is being published jointly by the Center on Budget and Policy Priorities and the Century Foundation; a more technical version of the study, also being released today, is available as a Brookings Institution working paper on the Brookings website.

The study finds that the private accounts the Commission proposed would significantly worsen Social Security's financial position, both in the short-term and permanently, by drawing funds from Social Security to subsidize those who elect the private accounts. The Commission proposals are able to restore long-term solvency, the study shows, only through very large transfers of tax revenues from the rest of the budget to compensate for the losses the private accounts would cause Social Security to incur. Under these proposals, the rest of the American public would, through these revenues, be required to subsidize those who elect to participate in the private accounts.

The study by Peter A. Diamond, Institute Professor and Professor of Economics at the Massachusetts Institute of Technology, and Peter R. Orszag, Senior Fellow in Economics at the Brookings Institution, draws heavily on a technical analysis of the Commission's proposals by the Office of the Chief Actuary at the Social Security Administration. It is the first study to examine a variety of effects implied, but not directly stated, in the actuaries' analysis. The Diamond-Orszag study of the two Commission proposals that are designed to restore long-term Social Security solvency shows the Commission proposals contain three principal components.

- First, the plans restore long-term balance to Social Security either solely (under one of the plans) or primarily (under the other plan) through Social Security benefit reductions. These benefit reductions would be large and would affect all beneficiaries, including disabled beneficiaries and those who do not elect private accounts.

- Second, the plans would replace part of the scaled-back Social Security system that would remain with a system of private accounts. Those choosing the individual accounts would have some of their payroll taxes diverted from Social Security to the accounts; in return, their Social Security benefits would be reduced further. The amount that Social Security would lose because of the diversion of these payroll tax revenues would, on a permanent basis, exceed the additional Social Security benefit reductions to which these beneficiaries would be subject. In addition, the accounts would create a cash flow problem for Social Security because funds would be diverted from Social Security decades before a worker's Social Security benefits would be reduced in return. The private accounts consequently would push the Social Security Trust Fund back into insolvency and permanently worsen Social Security's financial condition.

- To avoid insolvency and restore long-term balance, the plans' third component consists of the transfer of extremely large sums from the rest of the budget to make up for the losses that Social Security would bear because of the private accounts. The transfers would equal two-thirds of the entire existing Social Security deficit over the next 75 years under one of the Commission plans and 80 percent of the Social Security deficit under the other plan. (The second plan assumes additional transfers from the rest of the budget to reduce the magnitude of the Social Security benefit reductions it contains.)

The Diamond-Orszag study raises questions about where the trillions of dollars assumed to be transferred from the rest of the budget to offset the costs of the private accounts would come from, a matter on which the Commission is silent. Noting that virtually all budget forecasts show budget deficits outside Social Security for decades to come, with these deficits mounting as the baby boom generation retires – which means there are no surpluses outside Social Security to transfer – the study calls the Commission's reliance on large unspecified transfers from the rest of the budget a serious weakness of these plans. Financing the transfers would require large tax increases or deep cuts in other programs, but the Commission did not recommend any such changes.

Without the assumed transfers of trillions of dollars, the study shows, the Commission's numbers do not add up. "The assumed transfers in the Commission's plans effectively constitute a large 'magic asterisk' that serves to mask the adverse financial impact of the individual accounts on Social Security solvency," the study reports.

Benefit Reductions

The study also examines the effects the Commission plans would have on the benefits that workers receive when they retire. It finds that those who do not opt for the individual accounts would face deep benefit reductions.

- Under the Commission plan (identified by the Commission as "Model 2"), workers aged 35 today who retire at age 65 in 2032 and do not choose the private accounts would have their Social Security benefits reduced 17 percent, compared to the benefits they would receive under the current benefit structure. Benefits would be reduced 41 percent for those born in 2001 who retire at age 65 in 2066.

- As a result, the percentage of pre-retirement wages that Social Security replaces would decline substantially. For a two-earner couple with average earnings that retires at age 65 in any year after 2025, Social Security is scheduled to replace 36 percent of former earnings. Under the Commission's Model 2 plan, by contrast, Social Security would replace 30 percent of former earnings for such a couple that is 35 today and retires at age 65 in 2032, and just 22 percent of former earnings for a future couple composed of two individuals born in 2001 who retire in 2066. The study finds that under the Commission plans, the role of Social Security in allowing the elderly to maintain their standard of living in retirement would decline rather sharply over time.

Effects on the Disabled and Children of Deceased Workers

Benefit reductions would be particularly severe for the disabled and the young children of workers who die.

- For those who begin receiving disability benefits in 2050, Social Security benefits would be reduced 33 percent under one of the Commission's proposals and 19 percent under the other. (The benefit reductions could be smaller under the latter plan because it assumes the transfer of additional sums from the rest of the budget.)

- For those who begin receiving disability benefits in 2075, the benefit reductions would be 48 percent under one plan and 29 percent under the other.

- Equivalent benefit reductions would apply to the young children of deceased workers.

- These reductions would disproportionately harm African-Americans. Both the proportion of workers who are disabled and the proportion of young children whose parent or parents have died are higher among African-Americans than among the population as a whole.

Diamond and Orszag warn that the disabled and the children of deceased workers would have little ability to mitigate these severe benefit cuts with income from individual accounts, because many workers who become disabled would have had fewer work-years during which to contribute to private accounts, and also because the Commission plans would deny all workers — including the disabled — access to their accounts until they reach retirement age. The economists term the treatment of the disabled under the Commission plans as "draconian."

The Commission recognized its proposals would have such effects and stated it was not recommending these reductions in disability benefits. Diamond and Orszag show, however, that the Commission counted all of the savings from these disability benefit cuts to make its numbers add up. Without these benefit cuts, none of the Commission plans would restore long-term Social Security solvency (unless even larger transfers of revenue were made from the rest of the budget).

Impacts of Private Accounts

The benefit reductions just described would apply to *all* beneficiaries, including both those who do *not* opt for private accounts and those who do. Workers who choose the private-account option would be subject to additional reductions in Social Security benefits, on top of the reductions that would apply to all beneficiaries, in return for the income they would receive from their accounts.

For retired workers who received a return on their accounts equal to the average expected return that the actuaries and the Commission have forecast, the total reduction in benefits (factoring in the income from individual accounts) would be smaller. But many such workers still would face benefit losses.

- Under Model 2, a medium-earning couple that retired at age 65 in 2075 and received the average expected rate of return from a private account would receive a combined benefit — including a monthly annuity check from its account — that is about 20 percent below the benefit the couple would receive under the current Social Security benefit structure. Diamond and Orszag observe that given the large infusion of revenue from the rest of the budget under this plan, a 20 percent benefit reduction is quite substantial.

- Moreover, if the stock market does not perform as well in future decades as the actuaries and the Commission have assumed, private accounts investments would do less well than these figures suggest and the benefit reductions would be larger.

- The study also explains that because of the risk associated with investing in stocks, analysts generally agree that in comparing returns from different types of investments, adjustments for risk must be made. If the approach to "risk adjustment" that the Office of Management and Budget recently used in an analogous situation is applied here, the combined benefits from Social Security and individual accounts for the medium-earning couple retiring in 2075 are estimated to be 40 percent lower than the Social Security benefits the couple would receive under the current benefit structure.

The study warns that the large, unspecified revenues the Commission counts on from the rest of the budget might not materialize. If they did not fully materialize and payroll taxes were not raised, the benefit reductions would have to be still larger under these plans. Failure to identify a source for these revenues leaves Social Security subject to a substantial risk that the funding would not materialize.

Full copies of the report are available on the Center and Century Foundation websites (www.cbpp.org and www.tcf.org**.** A technical companion study is available on the Brookings website (http://www.brookings.edu/es).

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