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HOW WOULD THE PRESIDENT'S NEW SOCIAL SECURITY PROPOSALS AFFECT MIDDLE-CLASS WORKERS AND SOCIAL SECURITY SOLVENCY?

by Jason Furman

Summary

In a press conference on April 28, President Bush endorsed a proposal that would result in substantial cuts in benefits for middle-income families and deeper cuts for higher-income families. While the proposal was described as reducing benefits for the most affluent Americans, it would result in large benefit reductions for middle-class workers, as well.

- **All workers with income above $20,000 today would be subject to benefit reductions.** Seven of every ten workers would be affected. (Robert Pozen, the investment executive who designed this proposal, generally describes the cut-off as $25,000, but that is because he is using the expected cut-off in 2012, and expressing in 2012 dollars.)

- **The benefit reduction for middle-class workers would be large.** The size of the benefit reductions would escalate sharply in size as income rose above $20,000, until income reached $90,000. A worker making $35,000 today would be subject to benefit reductions more than half as large as those imposed on people at the highest income levels. A worker making $60,000 today would be subject to benefit reductions more than *85 percent as large* as someone making several million dollars a year. For a $60,000-a-year worker who retires in 2045, the benefit cut would equal about $6,500 a year.

- **Social Security *survivor* benefits would be cut by the same magnitude.** How *disability* benefits would be affected is unclear. (See below.)

- **For many workers, cuts would be deeper than if no action were taken and Social Security became insolvent.** The Social Security Trustees project the Social Security Trust Fund will be depleted in 2041. (The Congressional Budget Office projects this will occur in 2052.) The President has repeatedly characterized 2041 as the year when the system becomes "bankrupt" (an inaccurate characterization because the system would still pay 74 percent of scheduled benefits at that time). Yet for workers who now make about $55,000 or more, Social Security benefits would be cut *more deeply* under the benefit-reduction proposal the President now has endorsed than if nothing were done to restore Social Security solvency.

- **The benefit reductions for average earners would be the largest in Social Security's history.** The 1983 Social Security reform, for example, lowered benefits for average workers by 17 percent, with the reduction phased in over 46 years. The President's plan would lower benefits for average workers by 28 percent over a period of 70 years — and by considerably more than that for middle-class workers with incomes somewhat above the average, such as those who make $60,000 today.

Why the Benefit Reductions Are So Large

That the proposal entails such large benefit reductions for workers who are not affluent is the result of the President's apparent insistence on closing most or all of the solvency gap through benefit cuts, rather than — as was done in 1983 — through a balanced mix of benefit changes and new revenues. Under a balanced approach, benefit cuts of this severity could be averted.

Moreover, the plan is considerably less progressive than the President has presented it as being. The progressive price indexing proposal that the President has embraced applies the same size benefit reduction to people who make $90,000 as to people who make $9 million, and workers making $60,000 would be subject to a reduction nearly as substantial. A more balanced and progressive approach that included new revenues from those who could afford to pay them could restore sustainable solvency with significantly smaller benefit cuts for middle-class retirees and no net benefit cuts for people with disabilities.

Table 1

Reduction in Benefits Under Progressive Price Indexing

	Dollar Reduction	Percentage Reduction
Earnings of $36,600		
Worker retiring in 2045	$-3,253	-16%
Worker retiring in 2075	-7,629	-28%
Earnings of $58,560		
Worker retiring in 2045	-6,444	-25%
Worker retiring in 2075	-15,154	-42%
Earnings of $90,000 or more		
Worker retiring in 2045	-9,324	-29%
Worker retiring in 2075	-21,808	-49%

Source: Authors calculations based on Social Security Administration, Office of the Chief Actuary, "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing -- INFORMATION," February 10, 2005 and Social Security Trustees, *2004 Annual Report*. All percentage reductions in benefits for 2025-2075 are taken directly from the actuaries' memo

Effects on Disability Benefits

The President's proposed change in the Social Security benefit structure is essentially a plan known as "progressive price indexing," which has been designed by investment executive Robert Pozen. Analysis by the Social Security Administration's actuaries shows that Mr. Pozen's plan would reduce benefits for average earners retiring in 2075 by 28 percent, relative to the current benefit structure, and that this reduction *would apply equally to retirees, survivors, and people with disabilities.*[1] The actuaries also have reported that the benefit reductions under the Pozen plan would close about 70 percent of the 75-year Social Security shortfall.

[1] All of these benefit reductions are relative to the benefits scheduled under the current-law formula. This measure is consistent with the benefit baseline used to describe the shortfall in Social Security that needs to be solved. This issue is discussed in more detail in the Appendix.

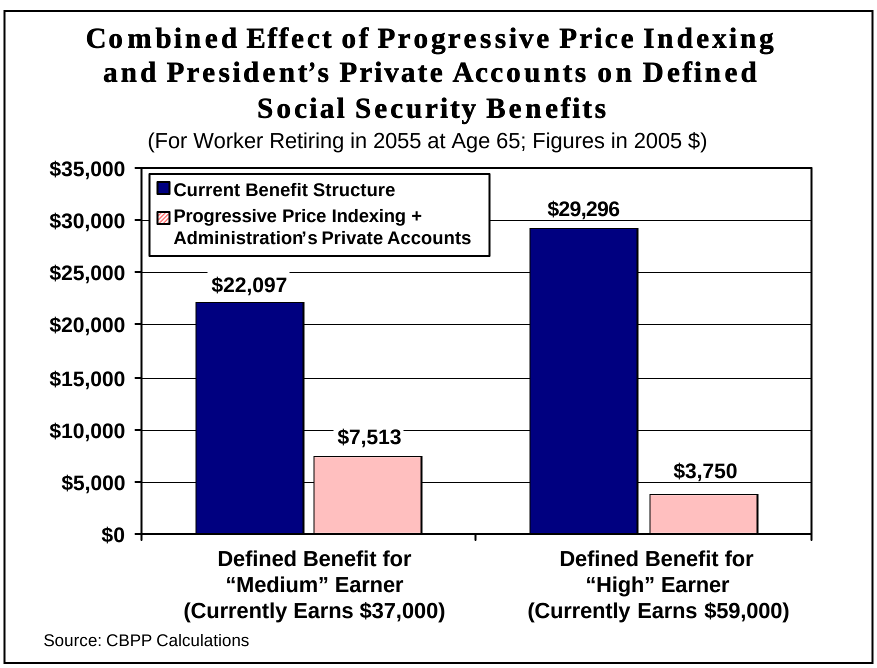
Defined Social Security Benefits Would be Lowered Further for Workers Electing President's Private Accounts

The President's proposal, as it now stands, combines Robert Pozen's "progressive price indexing" proposal with private accounts. The President has proposed that workers be allowed to divert payroll taxes equal to four percent of their wages from Social Security into private accounts. The cost of these accounts would be offset by reducing substantially the Social Security benefits of those who elect the accounts.

As a result, under the President's plan, defined Social Security benefits (for people electing the accounts) would be lowered twice — once due to the indexing changes, and a second time to pay for the accounts.

The resulting reduction in the Social Security benefits of those who elect the private accounts would be extremely large. Under the combination of the Pozen "progressive price indexing" proposal that the President has embraced and the President's private accounts, the defined Social Security benefit would be reduced by *66 percent* — from $22,100 a year to $7,510, in 2005 dollars — for a medium earner who retires in 2055. For a worker who earns 60 percent above the average wage, the reduction in Social Security benefits would be *87 percent* — from $29,300 a year to $3,750 (in 2005 dollars). In addition to this greatly reduced defined benefit, the worker also would get a private account that was subject to market risk.

Moreover, these figures reflect Social Security benefits *before* Medicare premiums are subtracted. (Medicare premiums are collected by being subtracted from Social Security checks.) Since Medicare premiums grow at the rate of health care costs, which is faster than either prices or wages, they will consume a steadily increasing share of Social Security benefits over time. For many middle-income workers, Medicare premiums would consume *most or all* of the very small monthly Social Security benefit that would remain under the combination of progressive price indexing and the President's private accounts. Social Security checks for millions of ordinary American workers thus would be close to or at zero.



The White House issued a fact sheet April 28 stating that its proposals, too, would close 70 percent of Social Security's financing problems. To do that, the President's plan either must cut disability as well as survivor benefits substantially — after all, one-sixth of the savings in the Pozen plan come just from reductions in disability benefits — or cut retirement benefits for middle-class workers even more deeply than the figures cited above (which are the actuaries' estimates of the benefit reductions under the Pozen plan). If the President's plan shields disability benefits from cuts, as the President implied — and does *not* cut retiree and survivor benefits more sharply than the Pozen plan — then it will close 59 percent of Social Security's 75-year shortfall, not 70 percent.[2] (The 59 percent figure also reflects the small cost of the poverty-level minimum benefit the President proposed in his press conference.)[3]

It should be noted that if the President's plan does protect disability *benefits*, many disabled *beneficiaries* apparently would still be subject to benefit cuts. Under Social Security, people who receive disability benefits are automatically converted to retirement benefits when they reach retirement age. Since retirement benefits would be cut under the proposal, people with disabilities would apparently see their benefits reduced at that time.

How the Pozen Proposal Works

Mr. Pozen has proposed changing the formula used to calculate Social Security benefits in a way that would reduce benefits, relative to the benefits under the current benefit structure. Under the Pozen plan, the magnitude of the benefit reductions would grow significantly over time and would be applied somewhat more to higher-income workers than to middle-income workers. Low-income workers would not be subject to the reductions.

More specifically, the Pozen plan would reduce certain factors used to calculate benefits for retirees, people with disabilities, and survivors (e.g., children of workers who die prior to retirement).[4] As a result, those receiving survivors and disability benefits would be affected. All three groups would get the same percentage reduction in their Social Security benefits.[5]

According to Pozen, his plan would "close the long-term deficit of Social Security by over 70%."[6] This is reflected in the estimates of the Social Security Administration's Office of

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[2] The Center previously released an estimate that the President's plan closed 59 percent of the solvency gap. That was based on the *2004 Trustees Report*, the report used to score the Pozen plan. This estimate is updated to reflect the assumptions in the *2005 Trustees Report*.

[3] The White House appears to be defending its 70 percent claim by saying that its proposal would eliminate 70 percent of the projected deficit in the *75th year* of the proposal. This is *not* the longstanding, widely accepted way of measuring the share of the long-term solvency gap that a Social Security proposal closes. The standard approach is to measure the percentage of the gap that a proposal would close over the next 75 years.

[4] The factors in question, known as the "PIA factors," are set at 90 percent, 32 percent, and 15 percent and are applied to a worker's average wages over his or her career when the worker's Social Security benefits are calculated. The Pozen proposal would add a new factor and gradually reduce the 32 and 15 percent factors.

[5] Social Security Administration, Office of the Chief Actuary, "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing -- INFORMATION," February 10, 2005.

[6] "Testimony on Progressive Price Indexing," Robert Pozen, 4/26/2005.

the Chief Actuary; the actuaries' estimates show that Pozen's proposal to change the Social Security benefit structure would reduce Social Security's actuarial deficit by 72 percent.[7]

As noted, about one-sixth of the improvement in solvency in the Pozen proposal comes from reductions in disability benefits.[8] A similar amount of the solvency improvement from the Pozen plan is the result of reductions in benefits for survivors, including children who get benefits as a result of the death of a parent prior to retirement. The remainder comes from reductions in retirement benefits

To Protect People With Disabilities, the President Would Need to Increase Pozen's Benefit Cuts for Retirees and Survivors by About One-fifth

The White House fact sheet states the President's "reform would solve approximately 70 percent of the funding problems facing Social Security." To achieve this goal and also protect disability benefits, as the President suggested last night that his plan would do, would require larger benefit cuts for retirees and survivors than the cuts the Pozen proposal would exact.

Protecting people with disabilities would result in about one-sixth less in solvency improvement than the original Pozen proposal. In addition, the President proposed a new minimum benefit for poor seniors, which would add a further, albeit modest, cost. If the proposal to shield disability benefits and the proposed minimum benefit are coupled with the Pozen plan's benefit reductions for retirees and survivors, the President's proposal would eliminate 59 percent of Social Security's 75-year deficit, rather than 70 percent. Eliminating the 75-year deficit is universally considered a necessary condition for any Social Security reform that achieves solvency.

For the White House statement that its plan would solve 70 percent of the deficit "by adopting a sliding-scale benefit formula, similar to the Pozen approach" to be correct if disablility benefits are protected, the White House would have to make the Pozen sliding scale more severe so that benefit cuts for retirees and survivors would be roughly *one-fifth larger* than those that would occur under the Pozen plan.

Larger benefit cuts for retirees and survivors may *not* be part of the President's plan. If so, the plan will not close anywhere near 70 percent of the 75-year Social Security's shortfall. If that is the case and the remainder of the solvency problem is to be solved through other benefit cuts, substantial additional benefit cuts will have to be proposed on top of those the White House is now endorsing.

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[7] Specifically, Table 2d of the actuaries memo shows that progressive price indexing would save $2.9 trillion in net present value over the next 75 years, or 1.36 percent of taxable payroll.

[8] Economists Peter Diamond and Peter Orszag have estimated that full price indexing would reduce benefits for disabled beneficiaries by 0.30 percent of taxable payroll over 75 years. This implies that the benefit reductions for disabled beneficiaries under "progressive price indexing" would save about 70 percent as much, or about 0.22 percent of payroll. The Social Security actuaries estimate that the Pozen proposal saves an amount equal to 1.36 percent of payroll over 75 years. Thus, roughly one-sixth of the total benefit reductions in the Pozen plan come from disabled beneficiaries. Peter Diamond and Peter Orszag, "Reducing Benefits and Subsidizing Individual Accounts: An Analysis of the Plans Proposed by the President's Commission to Strengthen Social Security," June 2002.

The Size of the Benefit Reductions Under the Pozen Proposal

Under the current benefit structure, initial Social Security benefits for each generation of retirees grow in tandem with average wages in the economy. This ensures that each generation receives Social Security benefits that reflect the living standards of its times. Full "price indexing" would make a change in the Social Security benefit formula so that initial Social Security benefits would keep pace only with prices, rather than wages, from one generation to the next. Because prices increase more slowly than wages, this would result in progressively larger benefit reductions over time and mean that Social Security benefits were replacing a steadily declining percentage of pre-retirement wages.[9]

The Pozen proposal would use price indexing to determine the benefits for "maximum earners," people who currently make $90,000 or more a year. Lower-earners — the bottom 30 percent of earners, or those who make less than about $20,000 currently — would continue to have their benefits calculated under the current formula. Anyone whose annual earnings over his or her career averaged between $20,000 and $90,000 would get a benefit somewhere between the currently promised benefit and the benefit that would be provided under full price indexing.

Estimates of Mr. Pozen's plan by the Social Security actuaries show that the plan's benefit reductions (relative to the benefits scheduled under current law) would grow sharply over time.[10] These benefit cuts would grow from six percent for an average wage worker born in 1960 who retires in 2025, to 28 percent for an average-wage earner born in 2010 who retires in 2075.

For a worker whose wages are 60 percent above those of the average worker, or about $59,000 in 2005, the benefit reductions under the Pozen proposal would grow from 25 percent — or $6,444 a year — for someone retiring in 2045, to 42 percent — or $15,154 a year — for someone retiring in 2075. For a maximum earner — someone who makes $90,000 or more in 2005 — the benefit reductions would grow from 29 percent, or $9,324 annually, for an individual retiring in 2045 to 49 percent, or $21,808, for someone retiring in 2075. (See Table 2.)

As these figures indicate, the benefit cuts for someone at $59,000 a year are nearly as large as those for someone who makes $90,000, or $900,000, or even $9 million a year. (Note: benefits under the current benefit structure are the most appropriate frame of reference for a variety of reasons, as discussed in the Appendix. Most fundamentally, these are the benefit levels that are used to calculate the Social Security shortfall, which the President has said his proposals would help to close.)

President's Plan is Not Balanced

[9] See Robert Greenstein, "So-called "Price Indexing" Proposal Would Result in Deep Reductions Over Time In Social Security Benefits," January 28, 2005.

[10] Social Security Administration, Office of the Chief Actuary, "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing -- INFORMATION," February 10, 2005.

The President's plan includes benefit reductions of this magnitude because it places most of the burden of closing the Social Security shortfall on benefit reductions and rejects closing the gap through a balanced mix of benefit reductions and new revenues. A more balanced approach would not require benefit reductions of this depth.

Table 2

Social Security Benefits Under Progressive Indexing For Workers Retiring at Age 65 In Various Years
(inflation-adjusted 2005 dollars)

	Current-law Formula		**Proposal**		**Change**	
	Benefit	Replacement Rate	Benefit	Replacement Rate	Dollar Reduction	Percentage Reduction
Scaled Low Earner (45 percent of the average wage, or $16,470 in 2005)						
2025	$9,718	49%	$9,718	49%	$0	0%
2045	12,041	49%	12,041	49%	0	0%
2075	16,599	49%	16,599	49%	0	0%
2100	21,820	49%	21,820	49%	0	0%
Scaled Medium Earner (average wage, or $36,600 in 2005)						
2025	16,009	36%	14,984	34%	-1,025	-6%
2045	19,837	36%	16,584	30%	-3,253	-16%
2075	27,344	36%	19,715	26%	-7,629	-28%
2100	35,945	36%	22,428	23%	-13,518	-38%
Scaled High Earner (160 percent of the average wage, or $58,560 in 2005)						
2025	21,228	30%	19,190	27%	-2,038	-10%
2045	26,302	30%	19,858	23%	-6,444	-25%
2075	36,254	30%	21,100	18%	-15,154	-42%
2100	47,658	30%	22,428	14%	-25,230	-53%
Steady Maximum Earner (taxable maximum, or $90,000 in 2005)						
2025	25,929	24%	22,999	21%	-2,930	-11%
2045	32,153	24%	22,829	17%	-9,324	-29%
2075	44,236	24%	22,428	12%	-21,808	-49%
2100	58,150	24%	22,428	9%	-35,723	-61%

Source: Authors calculations based on Social Security Administration, Office of the Chief Actuary, "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing -- INFORMATION," February 10, 2005 and Social Security Trustees, *2004 Annual Report*. Note that all percentage reductions in benefits for 2025-2075 are taken directly from the actuaries' memo.

Indeed, it may be argued that the President's plan is not progressive enough. As noted, his plan would apply the *same* magnitude of benefit reductions to a worker whose annual earnings average $90,000 as to one whose annual earnings average $9 million. Someone making $60,000 annually would get about 85 percent as large a benefit reduction as the individual who makes $9 million.

Other approaches would restore solvency with more balance between benefits and taxes, and also would take a *more* progressive approach to restoring solvency that ensures that people with very high incomes contribute significantly more than hard-pressed middle-class families. For example, the solvency plan designed by economists Peter Diamond of M.I.T. and Peter

Orszag of the Brooking Institution would gradually raise the payroll tax cap from $90,000 to $105,000 and impose a 3 percent "legacy charge" on income above the payroll tax cap. It also would modestly raise the payroll tax rate. It includes several significant benefit reduction measures as well, but its benefit reductions are roughly *half* the size of the benefit cuts that Mr. Pozen has proposed. Moreover, the Diamond-Orszag plan, which also includes a poverty-level minimum benefit, closes *100 percent* of Social Security's shortfall, not 59 percent or 70 percent.

Similarly, a plan proposed by former Social Security Commissioner Robert Ball and introduced last fall by Rep. David Obey would raise the payroll tax cap gradually from $90,000 to $150,000 and preserve a scaled-back version of the estate tax, with the revenues from the estate tax being dedicated to Social Security. The Ball plan includes benefit trims, as well, but here, too, the benefit reductions for average workers would be much smaller than the benefit cuts such workers would face under the Pozen and White House proposals. These approaches ask instead for somewhat larger sacrifices from very high-income households, which have benefited extremely handsomely from the generous tax cuts of recent years.

APPENDIX: SHOULD BENEFIT CUTS BE COMPARED TO SCHEDULED BENEFITS?

This analysis compares Social Security benefits under alternative plans to the Social Security benefits scheduled under the current benefit structure. Reductions in benefits are not objectionable *per se*; balanced Social Security reforms will generally entail some benefit reductions and some revenue increases.

The debate over Social Security is not improved by comparing benefits under various plans to current benefit levels adjusted only for inflation, or to "payable" benefits (the benefits that would be paid if no action were taken and Social Security became insolvent). There are several reasons why payable benefits, or current benefits adjusted only for inflation, are not the best standards to use in evaluating a proposal.

- **Citing a large Social Security financial shortfall is inconsistent with using "payable benefits" as the standard.** The President and other observers frequently say that Social Security faces a $4 trillion shortfall over the next 75 years (or in the President's more controversial statement, an $11 trillion shortfall over an infinite horizon). *These estimates are based on benefits under the current benefit structure*. The shortfall under the "payable benefits" baseline is zero. It makes little sense to use one benchmark for assessing Social Security's financing shortfall and another benchmark for assessing the solutions to the shortfall.

- **Using payable benefits contradicts common usage.** It is commonly said that restoring Social Security solvency will require benefit reductions, tax increases, or a combination of both. But under a "payable benefits" framework, this statement is incorrect. If only the "payable benefits" are supposed to be provided, there is no financing gap and no benefit cuts or revenue increases are necessary.

- **Replacement rates are the appropriate way to compare retirement benefits over long periods of time.** Social Security benefits are designed to replace a certain fraction of pre-retirement income. Under the current-law formula, they eventually replace 36 percent of income for the average retiree. Changes that lower this ratio constitute a reduction in benefits: they cause sharper declines in workers' standard-of-living when workers retire. Using "scheduled benefits" as the standard of comparison reflects this basic aspect of Social Security; using "payable benefits" as the standard does not.

- **Benefit changes should be measured relative to the benefits that people expect.** People expect benefits calculated under the current Social Security benefit structure. A reduction from that level should be described as what it is, a reduction in benefits relative to the current benefit structure.

- **Payable benefits are only one particular framework.** The "payable benefits" framework assumes that the *entire* adjustment to close Social Security's shortfall is done on the benefits side. A framework could just as well assume that payroll taxes would rise enough to eliminate the deficit. Under such a framework, for example, both the Pozen and Diamond-Orszag plans would be viewed as *cutting* payroll taxes relative to the levels needed for solvency. In short, adopting the "payable benefits" framework as the basic standard of comparison is arbitrary, as would be the adoption of a framework that simply assumed payroll taxes would be raised enough to eliminate the shortfall.

- **Any plan that solves less than 100 percent of the financing problem will generally be able to provide benefits that exceed payable benefits.** The White House benefit reduction plan would only solve 59 percent to 70 percent of the 75-year problem in Social Security. In Mr. Pozen's formulation, the remaining gap is closed by transferring $2 trillion to Social Security from the rest of the budget, even though the rest of the budget will be in deficit for as far as the eye can see and has no surplus funds to transfer. Any plan that does not fully restore solvency can ensure that benefits are higher than payable benefits. In such circumstances, using payable benefits as the principal standard of comparison can foster misleading impressions.