Joint Economic Committee Democrats

Senator Jack Reed (D-RI) – Ranking Democrat

Economic Policy Brief May 2005

How the President's Social Security Proposals Would Affect Late Baby Boomers

Introduction

The President's proposal for price indexing initial Social Security benefits and adding private accounts would affect all workers under age 55, including workers currently ages 40 to 50 who are in their critical years for retirement preparation. These late baby boomers would see reduced Social Security benefits from the President's price indexing plan, and, because they have fewer years until retirement, they would be more susceptible to stock market volatility and the likelihood of a further reduction in retirement income if they chose to contribute to a private account.

Workers currently ages 40 to 50 already face significant uncertainty about their economic security in retirement. Compared with earlier generations, fewer of these workers can count on receiving a traditional employer-provided pension or meaningful coverage under employer-sponsored retiree health insurance plans. Late baby boomers are more likely to have an investment-based employer pension such as a 401(k) plan, if they have pension coverage at all. Under investment-based plans, workers shoulder more of the responsibility for making adequate contributions to fund their retirement benefits and bear more of the investment risk that goes with managing their accounts.

Social Security provides the only remaining traditional retirement benefit for many workers. Social Security pays a dependable and predictable stream of income that is protected from inflation and that workers or their surviving spouses can't outlive. Cutting guaranteed Social Security benefits and replacing a portion of the remaining benefits with an investment-based program would undermine the retirement income foundation for many late baby boomers.

Impact of the President's Social Security Proposals

Partial Price Indexing. President Bush proposes to cut future benefits for workers earning more than $20,000 by changing the formula for calculating initial Social Security benefits. The current method for calculating initial Social Security benefits began in 1979. Since then the initial benefit level has increased each year with the growth in wages, ensuring that benefits reflect increases in living standards over time.

Under the President's proposal, labeled "progressive price indexing" by its proponents, the initial benefit level for workers earning $20,000 or less in 2005 would continue to increase with wage growth as under current law, while the initial benefit level for workers earning $90,000 or more would increase only at the rate of price growth–which is usually less than the growth in wages, especially over periods of many years. Workers in the middle would see their initial benefit level increase by a mixture of price and wage growth. The effect of this policy would be a substantial reduction in benefits over time compared with what is scheduled under current law.

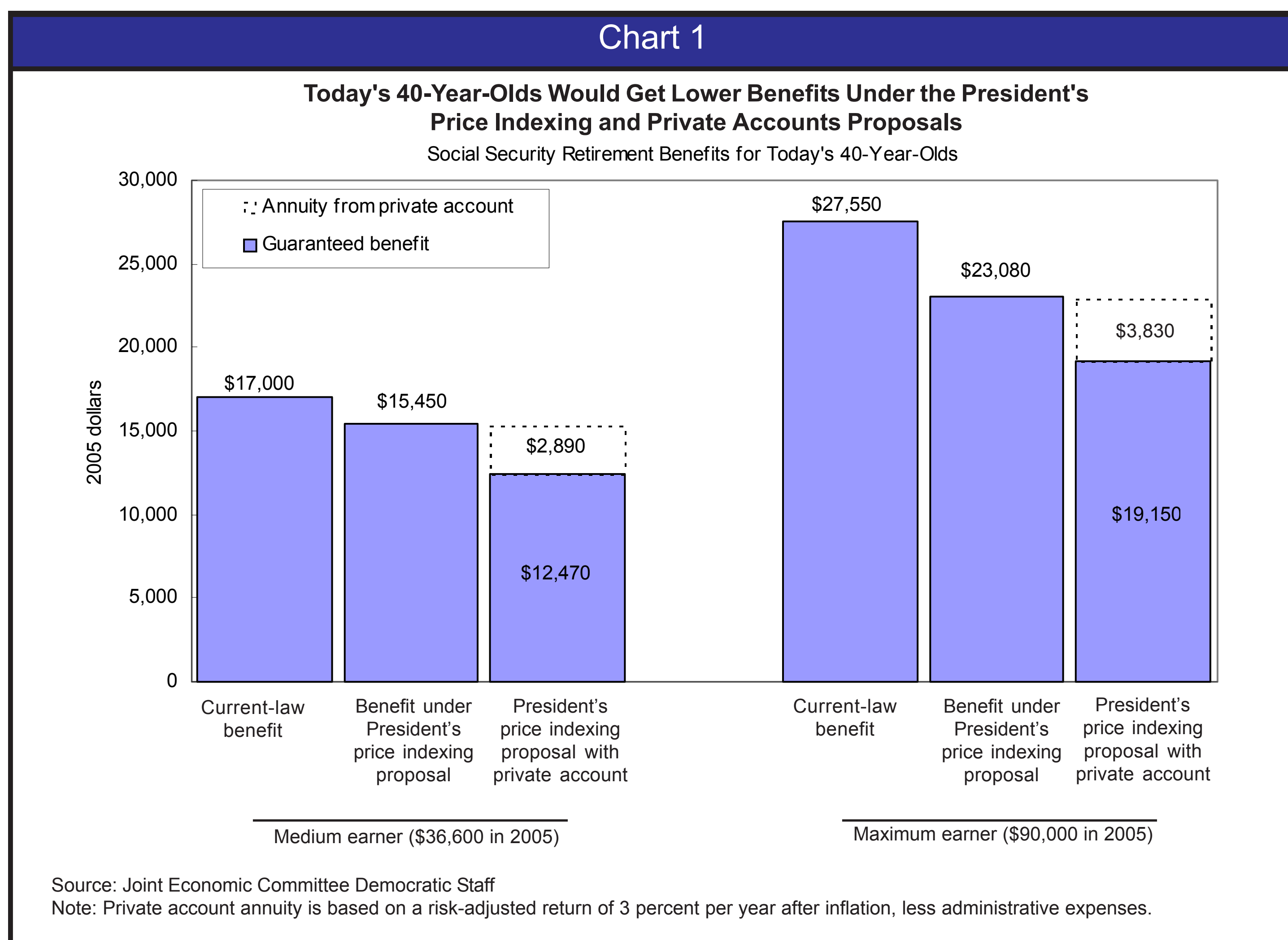
Private Accounts. President Bush also proposes substituting voluntary private accounts for a portion of traditional, guaranteed Social Security benefits. Under the President's plan, workers could contribute up to 4 percent of earnings (one-third of the current Social Security payroll tax of 12.4 percent) to a private account, reducing their Social Security payroll tax payments by the amount they contribute to their account. Workers could invest their account in a limited mix of stocks and corporate and government bonds.

At retirement, workers would be required to pay back the amount they contributed to private accounts, with interest, through a reduction in their guaranteed Social Security benefit. The interest rate on this benefit offset or privatization tax would be 3 percent above the rate of inflation (a 3 percent real rate).

Social Security Benefit Cuts. Both partial price indexing and the privatization tax would reduce guaranteed Social Security benefits. The benefit cuts from price indexing would be larger the further workers are from retirement (and thus the more years initial benefits are tied to the growth in prices rather than wages). The cut in guaranteed benefits from the privatization tax would be larger the more workers contribute to their private accounts and the longer they hold those accounts (and thus the more years over which the benefit offset rate compounds).

The cuts for late baby boomers would not be small. Partial price indexing starting in 2012 would reduce benefits at age 65 by 9 percent (from $17,000 to $15,450) for 40-year-old worker earning $36,600 today (**Chart 1**).[1] The benefit cut for a 40-year-old earning $90,000 (the current maximum for Social Secuirty contributions and benefits) would be 16 percent (from $27,550 to $23,080). This is a larger cut because full price indexing of initial benefits would apply to a maximum earner.

Workers opting to contribute to a private account would see a further cut in guaranteed Social Security benefits. Assuming that he or she contributes the maximum 4 percent of earnings starting in 2009, a 40-year-old worker earning $36,600 in 2005 would see an additional cut of 19 percent (from $15,450 to $12,470) in guaranteed benefits because of the privatization tax (**Chart 1**).[2] The guaranteed benefit after both price indexing and the privatization tax would be 27 percent less than under current law. The total cut in guaranteed benefits for a 40-year-old earning $90,000 would be 30 percent (from $27,550 to $19,150).



The total cuts in guaranteed benefits for workers ages 45 and 50 follow the same pattern, but are not as large because these workers would have fewer years of partial price indexing and fewer years in which to contribute to private accounts (**Charts 2 and 3**).

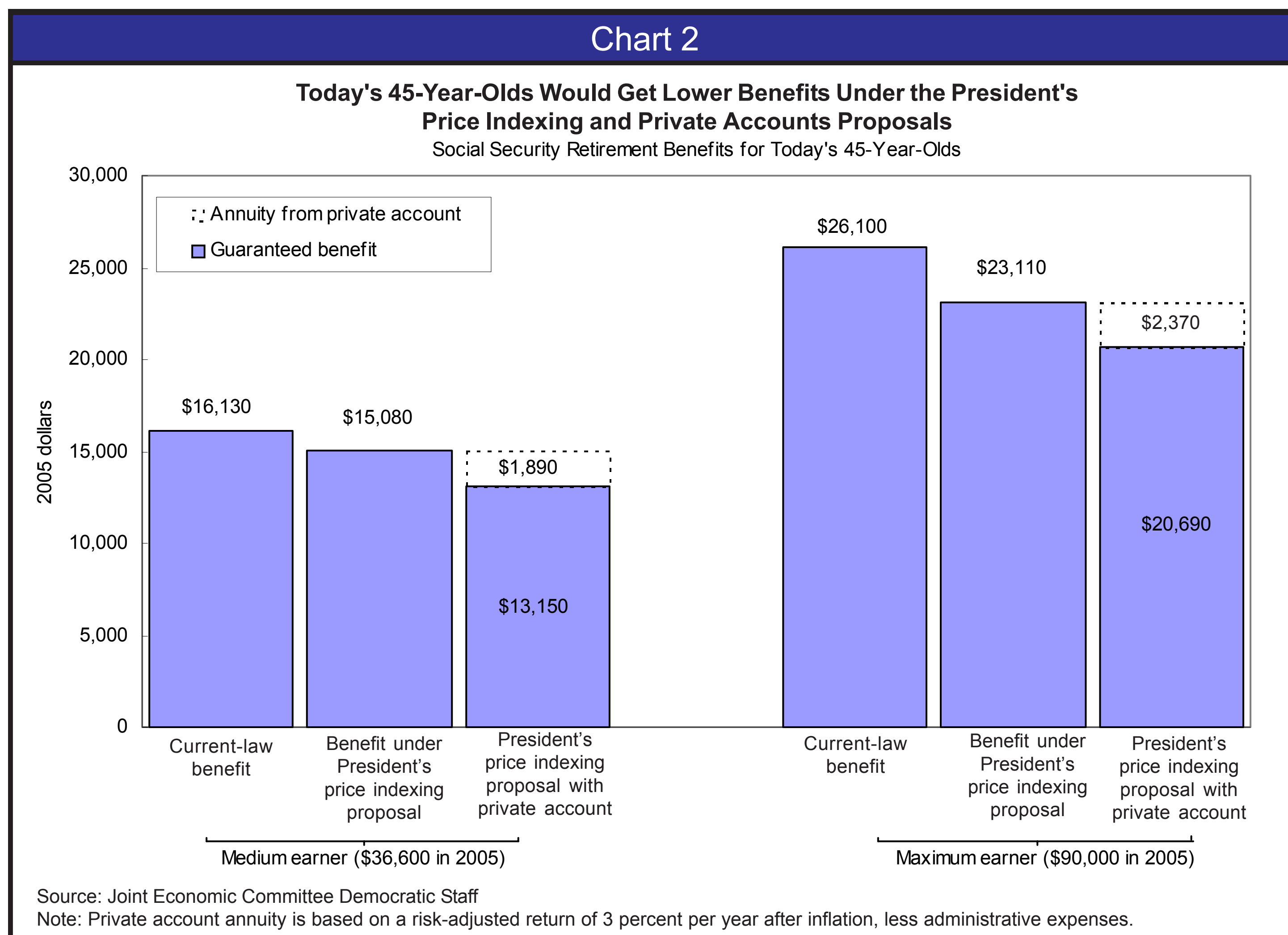
Risks of Private Accounts. Workers choosing to contribute to private accounts could recoup a portion of the lost guaranteed benefits from their individual accounts. The size of the payouts from their account would depend on the amount they contribute and the investment return on those contributions. Account holders would come out ahead only if they earned at least a 3 percent investment return after inflation and administrative costs.

If workers invested their accounts in risk-free government bonds, which, following the Social Security Actuary, are assumed to pay a 3 percent return after inflation, they would necessarily end up with a smaller payout from their accounts than the reduction in guaranteed benefits from the privatization tax. The difference is the result of administrative expenses, which are assumed to consume 0.3 percent of account assets (30 basis points) each year.

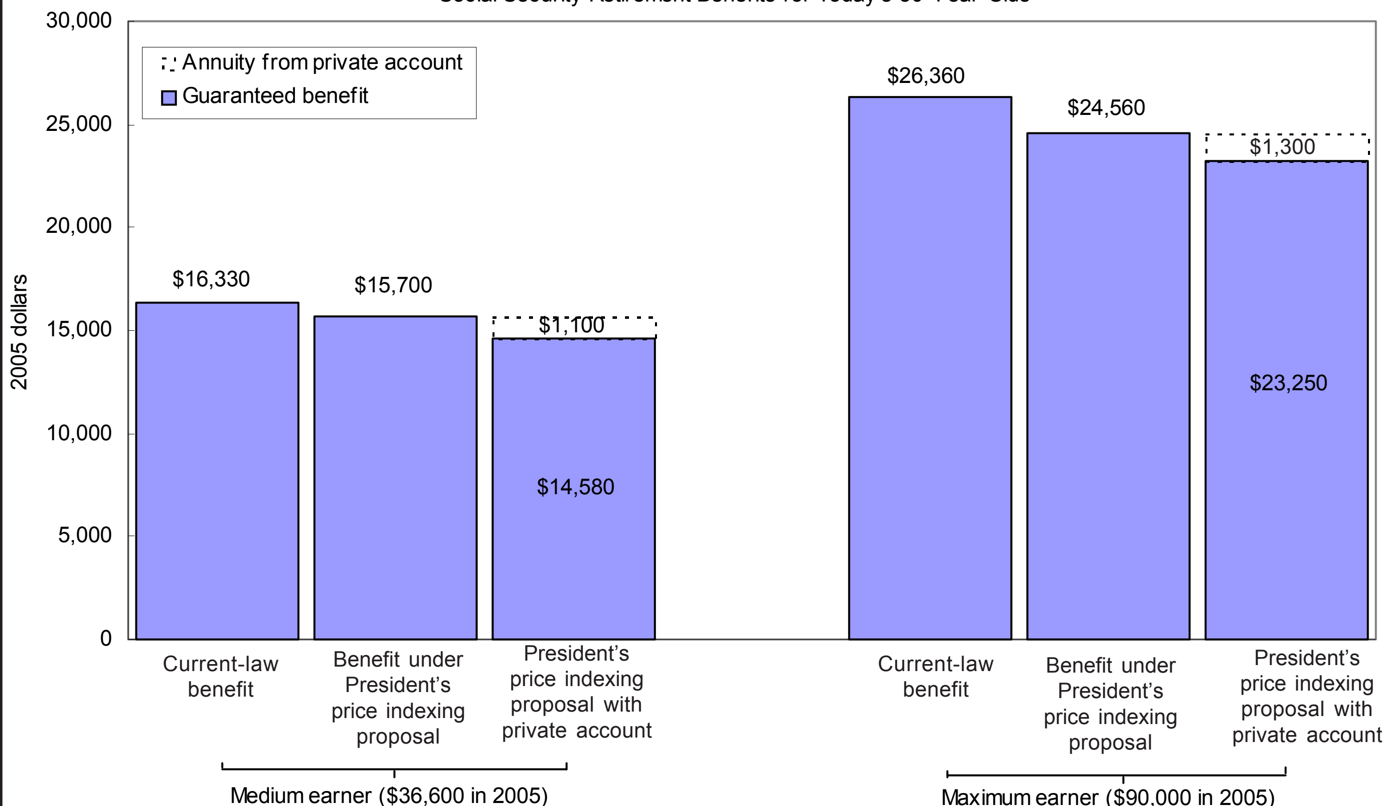
Following the Congressional Budget Office's methodology for estimating the expected payout from private accounts, Charts 1-3 show the annual income from a private account assuming a risk-adjusted return of 3 percent after inflation, less administrative expenses.[3] Workers are assumed to convert their entire account to an annuity (a stream of annual payments) at age 65.

Workers could receive a higher return if they invest at least a portion of their accounts in corporate stocks and bonds. Those investments carry risks, however, and there is also the chance that workers will earn even less than the return from risk-free government bonds.

A recent research paper by Congressional Budget Office (CBO) economists compared the returns from private



Source: Joint Economic Committee Democratic Staff
Note: Private account annuity is based on a risk-adjusted return of 3 percent per year after inflation, less administrative expenses.



account investments over different periods.[4] The CBO analysts examined a plan similar to the President's proposal for private accounts: workers could divert some of their payroll taxes into private accounts, and at retirement, would pay back these diverted taxes with interest. In the analysis, the interest rate for determining the amount workers would pay back was set at 3.5 percent after inflation. The CBO analysts assumed that workers would invest in an unchanging mix of stocks, corporate bonds, and government bonds that paid on average a 4.6 percent return after inflation and administrative costs, but which was subject to the actual historical variability of returns.

In their simulations, the CBO analysts found that workers who contributed for 15 years before retirement had a 50 percent chance of a negative outcome. That is, in half the simulations, the reduction in guaranteed benefits was greater than the annual payout from the account. In comparison, workers who contributed over 30 years experienced a 38 percent chance of being worse off, while those who contributed over a full career had a 28 percent chance of a loss.

These results show that the probability of losing money in an individual account is greater the fewer years workers have to contribute, if they maintain a fixed investment portfolio of stocks, bonds, and government securities. The actual probabilities of a loss will depend on the assumed rate of return and the interest rate used for the benefit offset.

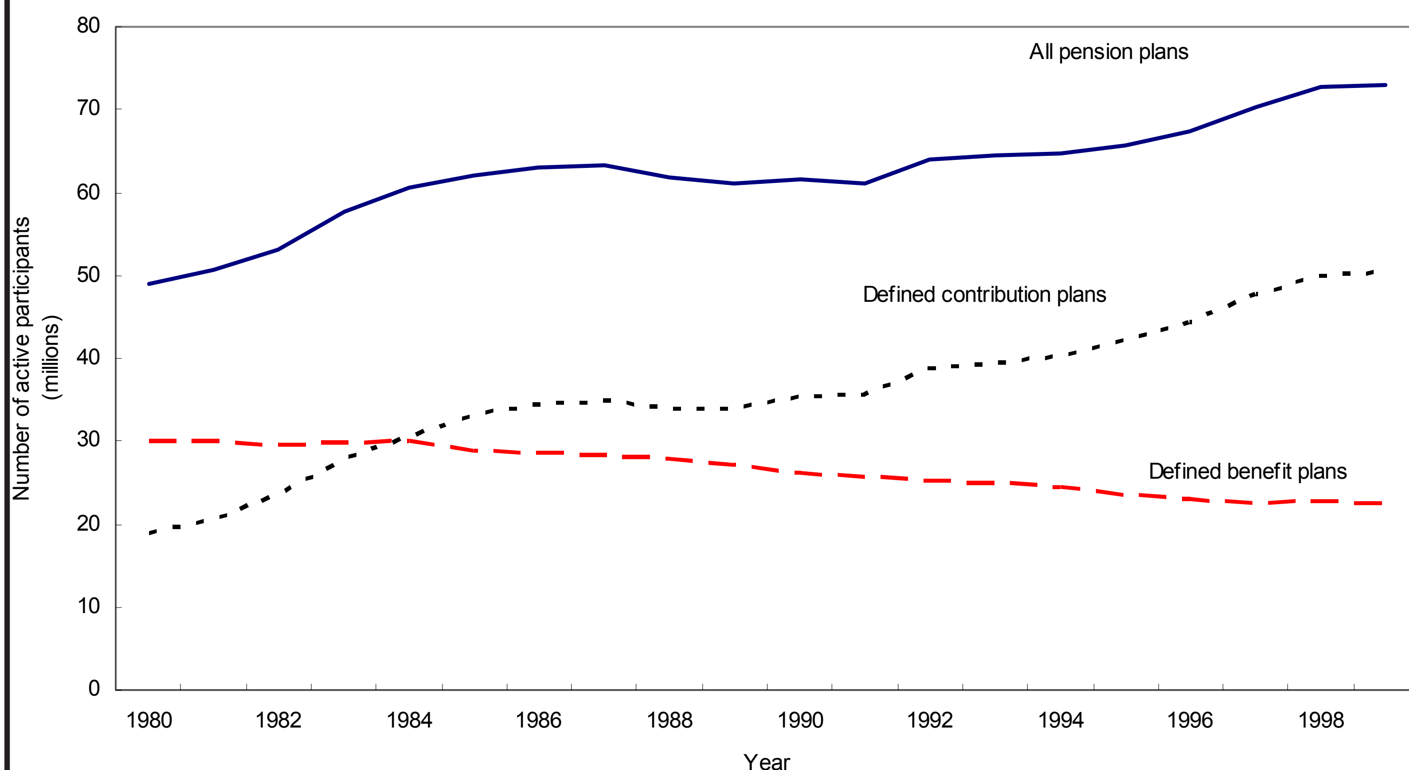
Some would argue that these results overstate the risk of private accounts because they assume that workers keep the same mix of stocks, corporate bonds, and government bonds in each year. Investment advisors usually suggest that workers should shift more of their investment out of stocks and into safer assets as they approach retirement, to reduce risks.

A recent research paper by Yale economist Robert J. Shiller explored what could happen to workers if they followed just such a strategy with their private account investments. Shiller's results suggests that if workers invest in "life-cycle" accounts–which President Bush has suggested as the appropriate default investment option–there is a 70 percent chance that they would do worse under private accounts than if they had stayed in the traditional system.[5] That is, based on historical returns for stocks and bonds in the United States and other developed countries, their investments would yield less than a 3 percent return after inflation and administrative costs seven times out of ten.

Shiller's results assume that workers invest in private accounts over forty-four years. Late baby boomers have a much shorter investment horizon before they retire. The investment returns from corporate stocks and bonds over a shorter period are more volatile, and carry a greater chance of returning less than investments in risk-free government securities.

The President's proposal for private accounts poses an additional risk for today's workers. In order to fund private accounts and pay benefits to current Social Security beneficiaries, the President's plan would require massive increases in federal borrowing and, as the administration acknowledges, would increase federal debt by trillions of dollars.[6] The President's plan would add about $5 trillion of additional federal debt in the first twenty years.

Commenting on the possibility that financial markets may not accept large increases in debt to fund private accounts as a simple trade-off between current debt and future Social Security obligations, Federal Reserve chairman Alan Greenspan observed "First, we don't know the extent to which the financial markets at this stage, specifically those trading in long-term bonds, are discounting the…contingent liability that we have. …And if we were to go forward in a large way and we were wrong, it would be creating more difficulties than I would imagine."[7]



Source: Private Pension Plan Bulletin, Abstract of 1999 Form 5500 Annual Reports, Number 12, Summer 2004. U.S. Department of Labor, Employee Benefits Security Administration.

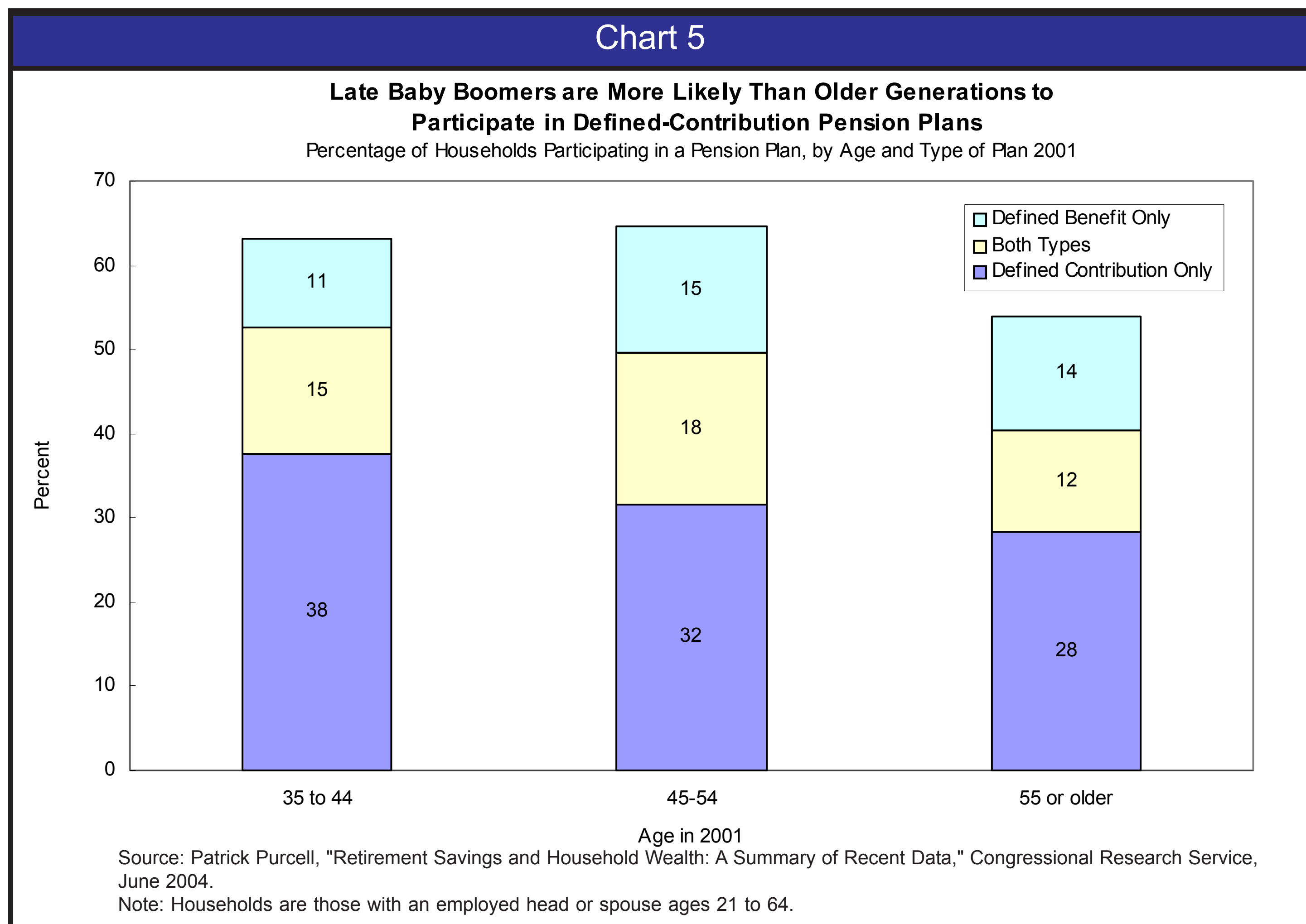
The massive increase in federal debt could roil financial markets leading to rising interest rates and a slumping economy. This could be especially painful for late boomers who would not be able to easily make up earnings and investment losses in the years just prior to retirement.

Increasing Private Pension Uncertainty

In the past twenty-five years there has been a major shift in employer pensions away from traditional defined benefit plans in which benefits are based on salary and years of service to defined contribution plans in which benefits are based on investment returns to employer and employee contributions. The number of participants in defined contribution (DC) plans has more than doubled, rising from 19 million in 1980 to 50 million in 1999, while the number of participants in defined benefit (DB) plans has fallen from 30 million to 23 million over the same period (**Chart 4**).

In 2004, private sector employers were more than four times more likely to offer DC plans than they were to offer DB plans. Among all private sector employees, twice as many participate in DC plans than participate in DB plans.[8]

The risks for employees are quite different between the two types of plans. In a traditional DB plan, the amount of a worker's retirement benefit depends on the length of time he or she stays with the firm and his or her final salary. The employer is responsible for investing pension funds and bears the costs if returns on those investments are lower than anticipated. In contrast, under a DC plan, the worker is responsible for investing the assets in his or her individual account and bears the risk of uncertain returns on those investments. The shift from DB to DC plans has meant that workers have increasingly assumed the risks and uncertainties of investing their own retirement assets.
Most late baby boomers with pension coverage participate in defined contribution plans. In 2001, when these workers were in their late 30s and early 40s, sixty-three percent participated in any type of employer-sponsored retirement plan with 53 percent participating in a DC plan. A significant fraction of late boomers (26 percent) still participated in



Source: Patrick Purcell, "Retirement Savings and Household Wealth: A Summary of Recent Data," Congressional Research Service, June 2004.
Note: Households are those with an employed head or spouse ages 21 to 64.

DB plans, however, including 15 percent who participated in both a DB plan and a DC plan (**Chart 5**) .

The amount of retirement income that workers can expect from a defined contribution plan is highly uncertain. Workers may hold too many risky assets, such as stock in one company or one sector of the economy, and end up losing money if that company or sector declines. They may also hold too many safe assets, such as government bonds, in which case returns are more predictable, but may be too low to produce sufficient income at retirement. There is also the risk that workers may not save enough in their accounts over a sufficient number of years, because they are either unable or unwilling to postpone current expenditures.

While the retirement income from defined benefit plans can be more predictable, DB plans carry their own risks. As workers in the steel and airlines industries well know, there is no guarantee that companies will make good on their pension promises. Short of defaulting on promised benefits, companies may also change the terms of their defined benefit plans to the detriment of older, long-service employees, as has happened in a number of conversions from traditional defined benefit plans to cash balance plans.

Since 1974, the Pension Benefit Guaranty Corporation (PBGC) has insured the benefits that workers have earned in defined benefit plans.[9] The PBGC will pay individual benefits if a company in financial distress terminates an underfunded plan. The maximum individual benefit PBGC will pay is just under $45,614 for a single-employer plan terminating in 2005. The guarantee is much less for workers who retire before age 65, however. Guarantees for workers in multi-employer plans (such as auto workers) are based on a percentage of benefits times years of service and often do not cover the full benefits that workers have earned.

The PBGC faces its own financial difficulties, however. PBGC's single-employer insurance program had a record deficit of $23.3 billion in 2004, as the result of large plan terminations in the steel and airline industries. The PBGC estimated that total underfunding in single-employer plans exceeded $450 billion at the end of 2004, although most of those plans are not in danger of termination.[10] The PBGC estimates that total under-funding in plans that may reasonably result in possible claims was $96 billion.

Disappearing Retiree Health Benefits

Not only is the retirement income of late baby boomers uncertain, but that generation can expect to bear more of the rising cost of health care in retirement. Few private firms offer health insurance coverage to today's retirees. In 2002, only 13 percent of all private-sector companies offered retiree health benefits, although coverage is higher among large employers and in the public sector.[11]

Because of the low coverage rate among many employers, many current retirees are without employer-sponsored health insurance coverage, and the number is growing. In two national surveys conducted five years apart, 29 percent of early retirees (ages 55 to 64) reported having retiree health benefits in 2002, compared with 39 percent of early retirees in 1997. Among Medicare-eligible retirees (ages 65 and over) 26 percent reported having retiree health benefits in 2002, compared with 28 percent in 1997.[12]

Among firms that continue to offer retiree health insurance, more firms have increased employee premiums and cost-sharing, or adopted access-only plans, which allow retirees to buy insurance through a group plan but which do not subsidize premiums. Among companies with 500 or more employees that offer retiree health benefits to early retirees, 38 percent required retirees to pay 100 percent of insurance premiums.[13]

The situation will likely be worse for late baby boomers when they retire. One in ten large employers that provide retiree coverage say that they are very or somewhat likely to terminate coverage in the near future, although most of those terminations are expected to apply only to new hires.[14] Most large employers say that they are very or somewhat likely to raise premiums and cost-sharing for retirees. Late boomers who are fortunate enough to have retiree health insurance coverage can expect to pay much more out-of-pocket costs for those benefits.

Conclusion

The President's proposal for price indexing benefits and private accounts would substantially cut guaranteed Social Security benefits for workers ages 40 to 50. These late baby boomers already face uncertainty about the security of their employer-sponsored pension and retiree health benefits.

Social Security provides the foundation for retirement income, but was never intended to be the sole source of income for workers to maintain their pre-retirement standard of living. If the President were serious about addressing the problem of Social Security solvency, he would not insist on private accounts that weaken solvency and require massive new federal borrowing. If the administration is truly concerned about the future retirement income security of most workers, it should work to strengthen existing defined benefit and defined contribution pensions that add retirement income on top of Social Security.

Endnotes

[1] The President has not specified a starting date for partial price indexing, but starting in 2012 is consistent with the President's pledge not to cut benefits for anyone age 55 or over today. It is also the starting date used by the Social Security Actuary to analyze the proposal that is the blueprint for the President's plan. See: Social Security Administration, *Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing –INFORMATION*, memorandum to Bob Pozen from Stephen C. Goss, Chief Actuary, February 10, 2005.

[2] Under the President's proposal workers could contribute 4 percent of earnings up to $1,000, starting in 2009. The $1,000 cap would increase by $100 each year and be indexed to keep pace with the growth in average wages. See: Social Security Administration, *Preliminary Estimated Financial Effects of a Proposal to Phase In personal Accounts-INFORMATION*, memorandum to Charles P. Blahous, Special Assistant to the President for Economic Policy, from Stephen C. Goss, Chief Actuary, February 3, 2005.

[3] See: Congressional Budget Office, *Long-Term Analysis of Plan 2 of the President's Commission to Strengthen Social Security*, updated September 30, 2004.

[4] Amy Rehder Harris, John Sabelhaus, and Michael Simpson, *Social Security Benefit Uncertainty Under Individual Accounts*, Contemporary Economic Policy, Vol. 23, No.1, January 2005, p 1-16.

[5] Robert J. Shiller, *The Life-cycle Personal Accounts Proposal for Social Security: An Evaluation*, March 2005.

[6] Christopher Lee, "Cheney: Social Security Plan to Cost Trillions," The Washington Post, February 7, 2005, page A02.

[7] U.S. Senate Committee on Banking, Housing, and Urban Affairs. Hearing on "The Federal Reserve's First Monetary Policy Report to Congress for 2005," transcript. February 16, 2005

[8] U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2004.*

[9] Information taken from Paul J. Graney, *Pension Benefit Guaranty Corporation: A Fact Sheet*, CRS Report for congress, January 5, 2005.

[10] David M. Walker, *Pension Benefit Guaranty Corporation. Structural Problems Limit Agency's Ability to Protect Itself From Risk*, Testimony before the Subcommittee on Government Management, Finance and Accountability, Committee on Government Reform, March 2, 2005.

[11] Agency for Healthcare Research and Quality, *Medical Expenditure Panel Survey, Index of Insurance Component Tables*, Table I Series for 2002. http://www.meps.ahrq.gov/Data_Pub/IC_Tables.htm

[12] Paul Fronstin, *The Impact of the Erosion of Retiree Health Benefits on Workers and Retirees*, Employee Benefit Research Institute, Issue Brief No. 279, March 2005. Figure 14.

[13] Mercer Human Resources Consulting, *National Survey of Employer-Sponsored Health Plans*, 2004. Report in Fronstin.

[14] Frank McArdle, et al., *Current Trends and Future Outlook for Retiree Health Benefits, Findings from the Kaiser/Hewitt 2004 Survey on Retiree Health Benefits*, (The Henry J. Kaiser Family Foundation, Menlo Park CA and Hewitt Associates , Lincolnshire, IL., December 2004)

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