

Achieving Long-Term Social Security Solvency

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Key Recommendations for Long-Term Social Security Solvency

1. **Progressive indexation of initial Social Security benefits.** SSA currently indexes initial benefits to wage growth, not inflation, with the result that initial benefits have been constantly increasing—after inflation—for decades. This reform would end this trend for upper-income workers.
2. **Use a chain-weighted index for existing benefits.** The inflation gauge SSA currently uses overestimates the true rate of inflation in the economy, as has been widely acknowledged.
3. **Index the retirement age to increases in longevity.** Longevity for people who reach age 65 increased by an entire year just from 2000-2007: without recognizing this trend in some way, all other reforms are simply insufficient.
4. **Base initial benefits on a worker's top 38 years of earnings.** The system currently uses the first 35 years of earnings, but increasing this to 38 years acknowledges the fact that people are working longer than ever—and further encourages this trend.

Social Security is in a precarious position. For starters, it is already hemorrhaging cash: it has been in deficit since 2010, nearly a decade prior to when the Social Security Administration's actuaries had forecasted its thirty-year run of surpluses would end. By 2030 Social Security's annual deficits will approach five percent of GDP, exceeding \$1 trillion.

Some suggest that the fact that the system now completely and totally transfers every single dollar of contributions (along with additional tax dollars that essentially come from the same group of people) from current workers to retirees makes the system akin to a Ponzi scheme. The difference, of course, is that the government mandates participation and prohibits people from leaving.

Demographics and the steady triumph of modern medicine have conspired against Social Security's solvency. The oldest members of the baby boom generation turn 65 in 2011 and threaten to swell the ranks of retirees in the next twenty years, with

successively smaller tax-paying cohorts to support them. What's more, dramatic progress in combating heart disease and cancer has led to steep increases in longevity, mainly for those people who manage to survive middle age. When the government created the Social Security program the life expectancy was scarcely sixty years of age, meaning that a substantial portion of the population would never live to collect any benefits.¹ In contrast, the current 65 year old can expect to live nearly twenty additional years, a span that has been increasing by as much as two months each year.²

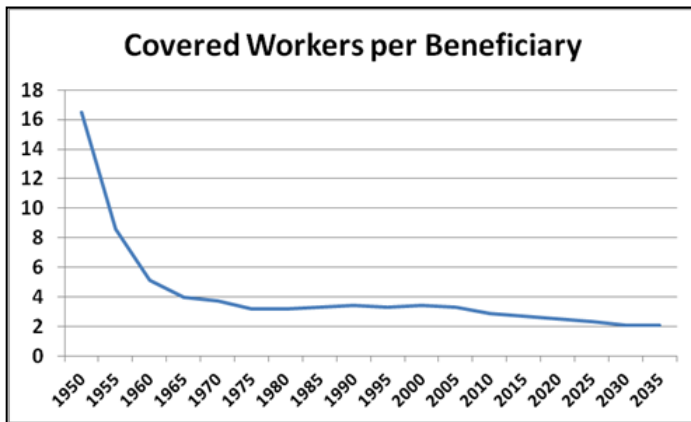
The result of this boon in longevity, as well as lower birthrates than a generation ago, is that the number of workers per Social Security beneficiary has been steadily

¹ [Life expectancy in the United States](#): Congressional Research Service Report, 2006.

² [Health, United States, 2010: With Special Feature on Death and Dying](#), Published by the National Center for Health Statistics.

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falling. As Figure 1 demonstrates, the ratio is on track to reach just two workers for each retiree by 2030.³



That more of us are living longer is of course a boon for society, but it does necessitate that we take certain steps so as to make sure our retirees are taken care of and our Social Security system survives. The fact that our government continues to insist that the program can go decades before being fixed is a sad indictment of our political system.

Fixing Social Security is not conceptually difficult: Unlike Medicare, where the inexorably rising yet unpredictable health care costs make long-term forecasts dicey, Social Security's long-term financial needs are easier to anticipate, and as a result easier to fix. What's more, it can be done while holding current retirees and near-retirees harmless, and at no cost to anyone's benefits.

By changing how the Social Security Administration (SSA) indexes benefits for inflation, automatically adjusting the retirement age so that it reflects growing longevity for seniors, and by altering the benefits calculation to reflect longer careers, we can return the Social Security system to a position of long-run solvency.

Progressive Indexation Of Initial Benefits

The Social Security Administration calculates the initial benefits of new retirees by averaging the highest 35 years of earnings of each recipient. Averaging across

such a long time horizon is not a straightforward calculation: since a fair amount of inflation occurs over the course of a worker's career, SSA has to account for it in some way. It does so by adjusting wages not based on some measure of price inflation but instead uses a measure of *wage* inflation.

There was no salient policy rationale for this methodology when it was initially established during the Ford administration: it was little more than a short-term palliative employed when a bureaucrat noted that price inflation had outpaced wage inflation in the recent past. It was hoped that using wage inflation would lessen the long-term costs of the program.

Of course, the trend of prices increasing faster than wages was short-lived: historically, wages have grown about one percent faster than prices, a manifestation of an expanding economy. Indexing initial benefits to wages means that the real, inflation-adjusted value of initial benefits increases by about one percent a year. Thus, if two men, ten years apart, were to make exactly the same salary—again, in inflation-adjusted terms—at every stage of their career, beginning at age 22 and up to retirement, the one who retires ten years later would receive Social Security benefits roughly twelve percent higher than his older comrade.

Defenders of the status quo have provided an *ex post* defense of indexing benefits to wages, stating that without such an indexation the standard of living of retirees relying on Social Security benefits will not keep pace with the rest of society, thus bringing them social and economic opprobrium.⁴ It is an argument that has won the day, at least for now; no serious proposal to move to a price indexation of benefits has been introduced to Congress, and the Congressional Budget Office has not bothered including an analysis of such a plan in its most recent publication that analyzed the various Social Security reform proposals.⁵

³ Data from the [2011 OASDA Trustees report](#).

⁴ See, for instance, [The Effect of using Price Indexation instead of Wage Indexation in Calculating the Initial Social Security Benefit](#), published by the AARP Public Policy Institute, 2002.

⁵ [Social Security Policy Options](#), CBO publication, July 2010.

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An NBER paper by Andrew Biggs, Jeffrey Brown, and Glenn Springstead estimates that full price indexation of initial benefits and the benefit endpoints would fully erase Social Security's projected long-run deficit of roughly 2.1 percent of taxable payroll.⁶

As a response to this political reality, economists suggested a modification to the indexation of initial benefits that would impose price indexation on upper-income households while holding harmless low-income households. Such a change, dubbed "Progressive Indexation" by its originator, Harvard Law Professor and MFS Investments Chairman Robert Pozen, would erase a substantial portion of the long-term Social Security shortfall. Pozen suggested that the income of the top five percent of all earners (measured over the 35 year earnings history) should be indexed for price inflation, the income of the bottom third indexed solely by wage inflation, and the earnings of everyone in between indexed by a weighted combination of wage inflation and price inflation, with the weighting depending on the level of income.

The primary complaint about such a reform⁷ is that it makes what is already a very progressive benefit structure even more progressive: as it currently stands, a retiree receives 90 percent of the first \$749 of his average monthly lifetime income, 32 percent of the next \$3768, and then 15 percent of the rest of his earnings up to the monthly maximum cap of \$8900, above which he does not pay taxes. By diminishing the returns on the upper income contributions, the benefits for those who have contributed greatly into the Social Security system become scarcely larger than those with significantly smaller contributions. We respond by pointing out that reducing benefits for upper-income taxpayers is greatly preferred to increasing their taxes, which is the only alternative.

Moving to progressive indexation would allow the system's balance sheet to benefit from increases in

economic growth, which is not currently the case. Currently, higher wages resulting from higher economic growth simply results in higher benefits for future retirees. In fact, scholars such as Jagadeesh Gokhale have suggested that this linkage means that higher economic growth actually makes the Social Security balance sheet *worse*.⁸

Progressive indexation formed the basis of President Bush's 2005 Social Security plan, which ran into substantial Democratic opposition, primarily due to his insistence that the plan also include the creation of personal retirement accounts to supplement promised Social Security benefits. If SSA began implementation of progressive indexation in 2017, CBO estimates that it would result in a reduction in the long-term unfunded liabilities of Social Security by about 20 percent.⁹

Change The Indexation Of Existing Benefits To A Chain-Weighted Index

While SSA uses a measure of wage inflation to aggregate and calculate the benefits of new retirees, it uses a standard measure of the Consumer Price Index, or CPI, to determine the annual increases necessary to insulate current retirees from the ravages of inflation. The problem with this approach is that statisticians estimate that CPI overestimates the true increase in inflation by roughly .5 to 1.0 percentage points per annum¹⁰.

The issue is that traditional measures of inflation have no way to take into account the inclination of consumers to substitute away from goods and services that experience a spike in prices. For instance, if we

⁸ *Social Security: A Fresh Look at Policy Alternatives*: [University of Chicago Press](#), 2010.

⁹ The number is a rough extrapolation from option 13 of [Social Security Budget Options](#), 2010, which would reduce the top two PIAs by one-third. Given that progressive indexation would impose a bigger reduction in growth on the top quintile we estimated that the savings from our plan would be moderately larger than the 16 percent from this alternative.

¹⁰ The 1996 [Boskin Commission](#), appointed by Congress to investigate the matter, determined that the Consumer Price Index overestimated inflation by roughly 1.1 percentage points. As a response to this the Bureau of Labor Statistics revamped its methodology, which resulted in the growth of C.P.I. being diminished by about .2 to .3 percentage points, or roughly one fourth of the amount of the estimated error.

⁶ *Alternative Methods of Price Indexing Social Security: Implications for Benefits and System Financing*. NBER working paper number [11406](#), June 2005

⁷ [Progressive Indexation](#). John Podesta, Center for American Progress, 2005.

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pretend that meat constitutes ten percent of a consumer's market basket and that meat prices increase by ten percent, then we might assume that the consumer will get socked with a one percent increase in the total cost of goods and services he buys. However, in such a situation nearly all consumers are going to consume less meat and more fish, beans, bok choy, or other, cheaper, alternatives. The true impact of the meat price increase will be much less than a one percent increase in overall costs.

There does exist an index that attempts to account for such behavior, called the Personal Consumption Expenditures Index. It tends to lag behind the CPI by about a half a percentage point, resulting in an inflation measure that is thought to measure the true rate of price inflation in the economy more precisely than the more-common CPI.

According to CBO's 2010 *Social Security Policy Options* report, moving to the Personal Consumption Expenditures Index or a similar price index, if introduced gradually, would reduce long-term outlays by about six percent.

Index The Retirement Age To Increases In Longevity

In 2008 esteemed broadcaster and host of NBC's Meet the Press, Tim Russert, died of a sudden heart attack at age 58. Besides the surfeit of tributes and encomiums there were not a few commentators who bemoaned the tragedy that was a life cut short.

What was left unsaid was that as recently as a generation ago an overweight man in his late fifties dying of a heart attack was entirely unremarkable. Since then, the routinization of heart bypass surgery and stents, the widespread adoption of statins, a marked reduction in smoking, and the ubiquity of defibrillators in public spaces has completely changed that reality, turning heart disease from a death sentence into a manageable condition.

It is one of the true successes of our society—and of our oft-maligned health care system—that longevity has been steadily increasing since the end of World War II, a trend that has been accelerating in the last decade.

What's more, longevity has been increasing the most at the tail end of the lifespan, affecting senior citizens more than any other cohort.¹¹ The Centers for Disease Control reports that the longevity for those who reached age 65 increased by an entire year from 2000-2007, after going up approximately six months over the entire preceding decade.¹²

This sea change in our health and longevity is an amazing societal achievement and one that should be viewed as an unalloyed benefit to society. The one rub, of course, is that we have a social security system that has left the retirement age largely in place since its inception in the 1930s, save for a **gradual two-year increase** that began in the last decade that in no way keeps pace with the post-65 longevity gains. As a result, retirees receive Social Security benefits much longer today than they did at any other time. **It is the increasing time that a retiree spends receiving benefits that has—more than anything else—led to the enormous shortfall the system currently faces.**

To address this issue a number of economists have proposed indexing the retirement age to increases in longevity. The most common reform suggested would alter the Earliest Eligibility Age (currently 62) and the Full Retirement Age (currently 66, but scheduled to go to 67 in by 2022) once each decade by the decennial gains in longevity for those age 65, to be phased in over the next decade.

In this case, the six month longevity increase among people age 65 would result in both early and full retirement ages rising by approximately one month every other year for the ensuing decade.

The amount of savings from indexing the retirement age to longevity would depend on whether the SSA indexed both retirement ages or just the Full Retirement Age, as well as how soon the increase in retirement ages would be implemented. For instance, the proposal CBO included in its *Social Security Policy Options* publication would merely index the Full Retirement Age (FRA) and

¹¹ [National Vital Statistics Report](#) vol. 58(19), May 2010, p7.

¹² [Health, United States, 2010: With Special Feature on Death and Dying](#), Published by the National Center for Health Statistics.

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not begin until 2023, when the age 67 retirement age is fully phased in, and it would increase the FRA so as to keep the ratio of working years and retirement years the same as it is today. Under such a scenario the retirement age would actually go up very slowly, and not reach age 70 until close to the next century.

A more aggressive plan would seek to keep the years spent in retirement constant and would begin immediately. The longevity gains from the previous decade would be incorporated into an adjustment of the FRA after 2022, when the gradual increase to an FRA of 67 concludes. Such a plan would produce larger Social Security Savings.

Base Initial Benefits On A Worker's Highest 38 Years Of Earnings Rather Than 35

The Social Security Administration calculates the initial benefits by applying its benefit formula—discussed earlier—to a recipient's top 35 earning years. This is a much different approach than most defined benefit plans, which usually allow benefits to be calculated on the basis of the earner's top three or even top one year of earnings, which makes it incredibly easy to game the system by loading up on overtime in a worker's last year, dramatically bumping up benefits.¹³

Social Security, on the other hand, not only uses more years to create the average annual income upon which it bases benefits, but it also caps the benefits (and taxes paid) on a worker's first \$106,800 per year. Thus, a worker's benefit more closely reflects his or her lifetime income.

However, some have suggested that since longevity and other trends are conspiring to create longer careers, perhaps the Social Security formula should reflect this

as well, and have proposed calculating benefits based on a worker's top 38 years of income, not 35.

Conclusion

Reducing Social Security's long-term shortfall is child's play, compared to the gargantuan task of doing so for the other entitlements: It is relatively straightforward to project future benefits (subject to longevity assumptions) as well as future revenues (subject to assumptions about employment/population ratios), making it much easier to forecast the effect of policy changes than it would be for Medicare, where the heretofore unceasing escalation of health care inflation foils all attempts to return it to solvency.

And while its long-run budget happens to be trillions of dollars in the red, it represents a pittance compared to Medicare's projected shortfall. Given the size and tractability, it behooves us to reform Social Security before getting to the heavy lifting of fixing the rest of our entitlements.

¹³ An extreme version of this game can be seen in the (all but bankrupt) Illinois pension system and the incredibly competitive battle to join a county board. In most counties this is a part-time, paid position that pays no more than \$5,000 per year, but it makes the board member a state employee. After twenty or so years of part-time employ, the board member then typically retires from his day job and finagles an appointment to a full-time government job for three years, thereby giving him a benefit that dwarfs his average annual salary.