

**BRIEF ANALYSIS**

No. 504

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## Social Security Reform: Looking at the Options

by Matt Moore

The present value of Social Security's long-term funding gap is \$11 trillion in 2004 dollars. That means we would need \$11 trillion in the bank today, earning the government's borrowing rate, to eliminate all of the program's future debt. Another way to reduce this debt is to reduce Social Security's obligations.

In his 2005 State of the Union address, President Bush outlined four approaches to reduce traditional, government-funded Social Security benefits. Combined with proposed personal retirement accounts, these measures could close the program's long-term debt while providing benefits that approximate what the current system promises:

- Increase the retirement age over time to match the rise in life expectancy.
- Discourage early retirement or increase the rewards for later retirement.
- Means-test benefits.
- Change the indexing of benefits from wages to prices.

Each of these reforms would cut benefits, and since each has been endorsed at various points by both Republicans and Democrats, they could form the foundation for a possible bipartisan agreement.

Some see these as alternatives to personal retirement accounts. However, if one or more of these measures were combined with privately-owned retirement ac-

counts, they could reduce Social Security's long-term debt while giving people the opportunity to earn back the money they lost.

**Increasing the Normal Retirement Age.** The normal retirement age is already rising for workers born after 1938. The retirement age began rising in 2003 by two months every year until it settles at age 67 for workers born in 1960 and later. Obviously, a higher retirement age means that retirees will collect benefits for fewer years, reducing Social Security's costs over time. The National Bureau of Economic Research estimates that this provision will reduce benefits by 24 percent for the average male retiree. The drive to raise the retirement age is understandable:

■ When the Social Security program was implemented in the 1940s, life expectancy at birth was only 61.4 years for men and 65.7 for women; since the normal retirement age was 65 years, most workers died before

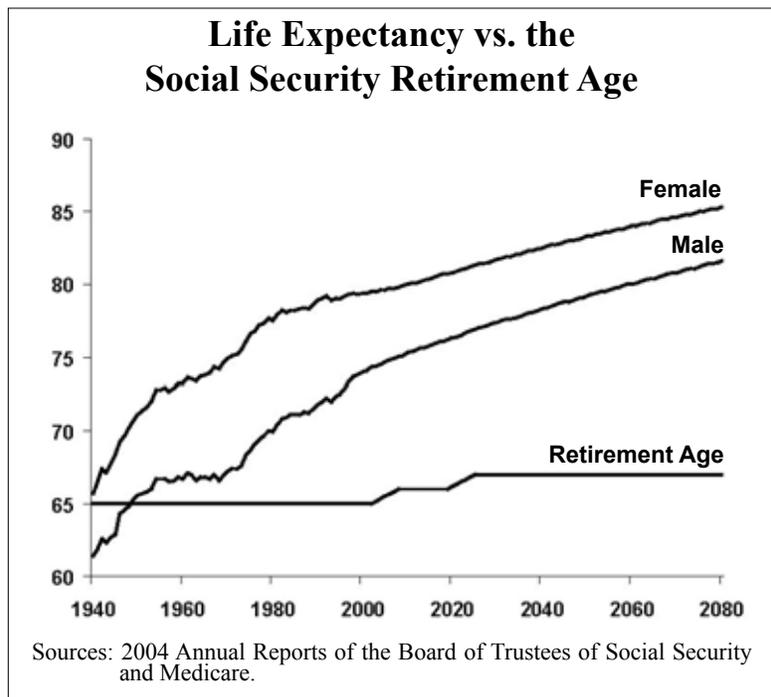
qualifying for benefits. [See the figure.]

■ Today, thanks in part to healthier lifestyles and the advancements of modern medicine, men are expected to live to age 74; women to age 79.

■ By mid-century, men are projected to live to 79; women to age 83.

In response to the continued rise in life expectancies, some have called for accelerating the increase in the normal retirement age to 67 years; others have called for gradually raising the age to 70. Neither measure would eliminate Social Security's debt, but could help somewhat. According to the Social Security Advisory Board — an independent board appointed to advise the Social Security Administration — accelerating the increase would close just 8 percent of the program's long-term debt. Raising

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the age to 70 would reduce the debt by about a third. But at what cost? Requiring aging people to work additional years in physically demanding jobs like factory work and construction is unfair.

**Discouraging Early Retirement.** While the normal retirement age is currently 65 years 2 months and rising, workers can still opt for “early retirement” at age 62. Today, almost 70 percent of workers retire early! Of course, early retirement leads to permanently reduced benefits; for example, a worker who retires at age 62 would receive monthly benefits 20 percent lower than if the worker had reached normal retirement age. By contrast, workers who wait to apply for benefits until after the normal retirement age receive a permanent bonus. Even so, encouraging people to work longer will reduce the number of years they collect benefits and reduce total benefits paid over time.

There are several ways to discourage early retirement. Both the early retirement and normal retirement ages could be increased, the formula for reducing early retirement benefits could be changed to lower them even further, the incentives for later retirement could be increased, or some combination of the three.

**Means Testing Benefits.** “Means-testing” — or reducing retirement benefits paid to workers with higher incomes or retirees with extra assets — is one of the most popular suggestions to reduce future benefit payments. The most common means-testing plan was developed by the Concord Coalition. It would reduce Social Security benefits by 10 percent for retirees with family incomes of \$40,000 a year and an additional 10 percent for every additional \$10,000 of income, up to a maximum reduction of 85 percent. The 1994-1996 Advisory Council on Social Security and a 2001 report by the Social Security Advisory Board suggest this plan could close three-fourths to 89 percent of Social Security’s long-term debt over the next 75 years. But means-testing specifically targets people who were responsible and saved more during their working years, a behavior we want to encourage.

Social Security currently redistributes benefits from rich to poor. While people who pay more taxes get a higher pension in retirement, the benefit structure is skewed so lower-income people get a higher return on their taxes than do wealthier people. Even so, Social

Security is social insurance, not a welfare program. As such, it is based on the notion that everyone who pays in gets something back. Means-testing violates this compact by forcing some citizens to pay the costs but receive none of the benefits, jeopardizing the program’s universal support.

**Changing the Indexing of Benefits from Wages to Prices.** Many of the leading reform plans before Congress — including Model 2 of the 2001 Commission to Strengthen Social Security, and a plan by Sen. Lindsay Graham (R-S.C.) — would change the indexing of initial benefit payments from wages to prices. Because wages rise faster than prices, this would slow the growth of future benefits and eliminate Social Security’s long-term debt. This provision will not affect the benefits of current retirees, and all workers — even those with reduced initial benefits — would continue to receive cost of living increases as prescribed under current law.

Because initial Social Security benefits are wage indexed under current law, the purchasing power of benefits is scheduled to rise. A person retiring in 2040, for example, can expect a benefit 40 percent higher than today’s retirees receive, in real terms. Tying future benefit increases to prices would give future retirees the same purchasing power as today’s retirees, but would replace a smaller portion of a future worker’s preretirement income.

Those most affected would have more time to make other arrangements for their retirements. A 47-year-old today would receive 90 percent of currently scheduled benefits upon retirement. Benefit levels decline to 85 percent for 37-year-olds and to 74 percent for today’s 27-year-olds. This proposal could also be made progressive by subjecting higher-wage workers to price indexing while lower wage workers continue under wage indexing.

**The Role of Personal Retirement Accounts.** Regardless of which method Congress eventually adopts, today’s younger workers and future generations face additional burdens. Adding a personal retirement account to any of the options outlined above will give younger workers a way to make up their losses.

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