Social Security Benefit Expenditures, How Benefits Have Changed Over Time, Options for Change and Their Impact

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Summary

Average wage workers who are coming to retirement today will have laid aside three times as a much of their lifetime earnings to secure their retirement benefits as similar individuals retiring in 1955 and nearly twice as much as one retiring in 1975. Today's retiree will have given up nearly an added six years of earnings for retirement compared to the 1955 retiree. Add in the growth in health costs and the higher costs are more than nine years of earnings. These costs are projected to go considerably higher as a share of earnings in the future and we must consider ways to moderate their further growth or we threaten the prosperity of future generations.

Beyond considerations of cost, there are equity concerns raised by the current benefit structure in an economy that has changed in fundamental ways since the beginning years of the program when the current benefit architecture was put in place. We need to modernize the system.

The spousal benefit that was intended for stay-at-home spouses who were homemakers and guardians of their children made sense in 1939 when few married women worked outside the home. In modern times, the benefits delivered by this feature are meaningless to most women and defeating the redistributive characteristics of the plan designed into the benefit formula. These latter features have been repeatedly reaffirmed by Congress over the decades.

In lieu of the spousal benefit it is time to add a joint and survivor feature for married couples. Congress mandated such a benefit as the normal form of annuity for private pensions in 1983 because of the economic and equity benefits provided by such a feature. This addition does not need to raise program costs but could help to ameliorate poverty rates among elderly widows and make the total benefit more equitable to married working women who, along with single workers, are currently treated inequitably under the current spousal benefit.

Statement

Mr. Chairman and members of the Subcommittee on Social Security of the Ways and Means Committee of the U.S. House of Representatives, thank you for inviting me to testify

before you at this hearing regarding Social Security benefits. The focus of my remarks is on the need to consider some benefit changes to the program and two specific aspects of Social Security's benefit portfolio that should be modernized to improve the effectiveness with which the program meets one of its specific long-term goals. This goal has been repeatedly reaffirmed by legislative updates and is a central element of recent recommendations made by both the National Commission on Fiscal Responsibility and Reform and the Debt Reduction Task Force.

Social Security was conceived and became law in the midst of the Depression. It was signed into law on August 14, 1935 and the first benefit check was paid in January 1940. Robert M. Ball, former Social Security Commissioner, was arguably the most influential figure in the development and support of Social Security from the 1950s through 2008 when he passed away. His assessment of the program was that:

> The pattern of the program was well set in the [19]39 amendments. One way to consider the whole history of the program from then on is as filling in the structure that had been created in '39. You had to extend coverage; you had to create programs for the two risks that were not included, disability and health--health insurance for the elderly, at least. But everything was an elaboration of the basic structure and ideas.[1]

Some people point to the fact that Social Security's benefit structure has been relatively stable since the 1930s as a great achievement. If we were a society with unlimited resources, I might share that view but we are not and I do not. The world has changed dramatically since 1939 and the cost of providing a benefit portfolio that made sense then has come now to be overly burdensome for many workers. It is important to keep in mind that Social Security is just part of the package that workers must finance in protecting against what President Franklin Roosevelt called the "vicissitudes of life."

Growing Costs Swamping Workers' Compensation Growth

Many people today have a strong intuition that our financing of security benefits is taking an ever larger share of our resources but lack the evidence to document their conclusion. In order to understand what is behind the intuitions consider the case of a worker, Jane, who begins her career at age 21 and earns average wages in each year until reaching age 65 when retiring and claiming Social Security benefits.

If Jane reached age 65 in 1955, she and her employer(s) would have paid the equivalent of 2.1 percent of her lifetime wages to finance her Social Security. However, if she reached age 65 at the beginning of 2011, the full career cost of payroll taxes on her earnings would have been 13.1 percent of her lifetime pay. The average cost rates at various other years when she might have turned age 65 are shown in the second column in Table 1. At almost every point in time, she would have qualified for a benefit that was around 40 percent of final pay but the cost would have varied significantly depending on when she retired. The Jane who retired in 2011 would have paid more than 6 times as much as the one who retired in 1955.

Over the period covered in Table 1, Jane's retirement period would have increased by about four years between 1955 and 2011 because of earlier retirement in the later years. Her

improved life expectancy over the intervening period would have added a couple more years. The third column in Table 1 shows the results of some calculations of the savings rates required to finance a benefit for Jane that would replace an additional 40 percent of her final earnings as a supplement to her Social Security pension. In developing the calculations, I assumed that she received pay increases of 4 percent per year throughout her career and that her retirement savings were invested at a constant 7 percent return each year. I assumed that her retirement benefit from this portion of her retirement portfolio would increase 2 percent per year during her retirement to cover at least part of the cost of inflation.

Table 1: Cumulative Lifetime Employee plus Employer Social Security Payroll Taxes as a Percentage of Cumulative Lifetime Earnings, Supplemental Retirement Savings Rate, Employer Average Contributions for Health Benefits and Totals as a Percentage of Pay for Workers Retiring at Various Specified Dates

Year reaching age 65	Lifetime payroll tax as percentage of lifetime earnings	Required supplemental savings rate	Total retirement cost per year	Annual health benefits cost	Retirement plus health costs
	(All amounts stated as a percentage of salary or wages)				
1955	2.1	4.6	6.7	1.0	7.7
1965	3.6	5.4	9.0	2.1	11.1
1975	5.9	5.9	11.8	3.5	15.3
1985	9.0	6.1	15.1	5.6	20.7
1995	9.9	6.7	16.6	8.0	24.6
2005	12.0	7.1	19.1	9.9	29.0
2011	13.1	7.5	20.6	10.6	31.2

Source: Sylvester J. Schieber, *The Predictable Surprise, the Demise of the 20th Century Retirement System and the Way Forward* (New York: Oxford University Press, forthcoming in 2012), Chapter 21.

Column 3 in Table 1 shows that for the Jane retiring in 1955, she or her employer would have needed to be putting aside 4.6 percent of her pay each year in her career under my assumptions to finance her supplemental benefit. For the one retiring in 2011, this would have increased to 7.5 percent of pay because she would have had a shorter number of years over which to accumulate her savings and a longer number of years in which she was depending on them. The change in the cost of the supplemental savings rate is much smaller than in the case of Social Security because of the relative efficiency of funded pension systems.

The fourth column in the table helps to explain why many people today are finding the financing of their retirement a more daunting task than our parents and grandparents faced. That column sums the percentage of payroll costs that workers of various vintages experienced from Social Security and needed supplemental savings. For the individual retiring in 1955, a combination of Social Security and roughly a matching supplemental benefit would have cost him or her something less than 7 percent of lifetime earnings. For a similar worker retiring in 2011, the cost would have been nearly 21 percent of earnings. To put this in a slightly different

context, the generation coming to retirement in 2011 would have had to surrender roughly six additional years of their lifetime earnings to meet their retirement needs than the one that retired in the mid-1950s. Some of this added cost was self induced because of earlier retirement ages despite increasing longevity but this is a relatively small part of the cost increases in the table.

The fifth column in Table 1 has nothing to do with retirement, per se, but it is centrally related when we consider that workers' health benefits are also financed out of the same compensation budgets that are used to finance retirement. The numbers in this column of the table are the average total employer costs for benefits provided under their health care plans stated as a percentage of total employer costs for cash wages in the years listed in the left column of the table. These are not lifetime averages as the previous columns were but the costs toward the end of workers' careers at the respective points in time. These averages are based on total wages paid to all workers including both those who were participating in an employer-sponsored health benefit plan and those who were not. The average costs for those in plans would have been considerably higher if the non participants' pay was removed from the calculations. The data in the table also does not reflect the workers' own premium payments and out-of-pocket expenses when they enroll and utilize employer-sponsored health benefits.

The right-hand column in Table 1 sums up the retirement costs from the fourth column and the health benefit costs from the fifth. The combined components in the table suggest that the cost of providing workers today retirement and health benefits commensurate with what earlier generations enjoyed, on average, will cost somewhere around the equivalent of 31 percent of their pay a full 24.5 percent of pay more than it cost to cover these contingencies for the worker coming to retirement in 1955. A cost of 23.5 percent of pay over a 40-year career is the equivalent of 9.5 years' pay—a significant cost from almost any perspective.

From young workers' perspective, the payroll tax cost in the second column of Table 1 will climb to 15 percent of lifetime earnings by 2020 and health costs, unless we stem health inflation, could climb to 14 percent of earnings. The total costs will climb to as much as 36 percent of pay by 2020 under conservative assumptions. If we simply resolve Social Security's financing problems by waiting until the trust funds are nearly depleted and then raise tax rates to meet shortfalls, we would add another 4 percent to the Social Security payroll tax. The Medicare claim could be even larger. I believe it would be unconscionable to do this to our grandchildren. Instead we ought to look to ways to modernize our Social Security benefit structure to meet our stated goals and save some resources at the same time.

Social Security Benefit Progressivity, an Unachieved Goal

In 1935, Congress adopted the Social Security Act that called for workers with lower lifetime earnings to receive relatively larger benefits than workers who had higher earnings. On 12 subsequent occasions, the Congress has reaffirmed that redistributive benefit structure when it passed Amendments to the Act.[2]

For years, the Social Security actuaries have developed analyses of "money's worth" for program participants. In these analyses, they focus on specific birth cohorts and consider their lifetime contributions to the system, including those made by their employers on their behalf,

accumulated with interest. They compare the lifetime contributions in each birth cohort to their lifetime benefits in present value terms. In terms of contributions, all payroll taxes—both the worker's and employer's share—for Social Security benefits are included. The contributions and accumulating balances are credited interest at the rates that the bonds in the trust fund earned interest. In developing their estimates of Social Security money's worth values for hypothetical workers, the actuaries account for the comprehensive package of benefits provided by the system including retirement, disability and the various forms of survivor benefits provided by the system. The most recent analysis of this sort included results for 11 different birth cohorts ranging from the first born in 1920 to the last born in 2004.[3] For this discussion, I focus on the results for the 1949 birth cohort. The results of the money's worth calculations for the 1949 birth cohort are in Table 2.

Table 2: Expected Value of Social Security Benefits Relative to Accumulated Lifetime Contributions with Interest for Hypothetical Workers Born in 1949, Retiring at age 65 by Earnings Level

	Single male	Single female	One-earner couple	Two-earner couple
Very low	1.25	1.41	2.47	1.41
Low	0.91	1.02	1.81	1.03
Medium	0.67	0.76	1.36	0.77
High	0.56	0.63	1.12	0.64
Maximum	0.46	0.52	0.92	0.52

Source: Michael Clingman, Kyle Burkhalter, Alice Wade, and Chris Chaplain, "Money's Worth Ratios under the OASDI Program for Hypothetical Workers," *Actuarial Note* (Office of the Actuary, Social Security Administration, July 2010), no. 7, pp. 9-10, found at: http://www.socialsecurity.gov/OACT/NOTES/ran7/index.html.

The workers in the 1949 birth cohort were assumed to begin working at age 21 in 1970 and to work continuously until the end of 2013 and to retire on their 65th birthday at the beginning of 2014. The entry of 1.25 for the very-low earning single male implies that such an individual can expect to receive a benefit from Social Security that is 1.25 times the value of his lifetime contributions plus his employer's accumulated at trust fund interest rates. At each higher lifetime earnings level, the value of the benefit relative to contributions falls. For a worker at the maximum earnings level throughout his career, the expected benefit is just 46 percent of the value of lifetime contributions. This clearly reflects the redistributive characteristics that the original plan architects and President Franklin Roosevelt intended when they put the initial legislative proposal together. It has varied somewhat over the years but the changes have been marginal. The fact that the expected value of lifetime benefits is less than the value of lifetime contributions on a worker's earnings in several cases is related to the pay-as-you-go financing of the system.[4]

The benefits for single women relative to their contributions are somewhat higher at every earnings level than they are for men. At a given earnings level, their accumulated contributions would be equal under the assumptions and methods used to calculate the ratios in

the table. The reason that single women appear to do somewhat better than men is because of their longer life expectancy. They can expect to receive an extra three years of benefits, on average than men. It does not mean that they receive higher benefits at the date they retire or in any month during their retirement. These ratios can serve a valuable purpose in thinking about the program but they should not be the only thing considered when thinking about it.

One-earner couple's benefits are by far the most generous in the system. Total benefits are 150 percent of the benefit payable to the worker, actuarially adjusted for the age at which benefits are taken, and will continue at that level until the first member of the couple dies; then it drops to 100 percent of the worker's benefit. In most cases where there is only one member of a couple who has worked in covered employment during their lives, it will be the male who is the worker. The money's worth of the couple benefit for one-earner couples doubles that of the single male. Where both members of a couple work, the money's worth is equivalent to that achieved by single women. Given the longer life expectancy of women, when the husband dies in these types of cases, the wife's benefit is the higher of the two paid to them when both are alive. In most cases, that would mean an increase in the benefit for the surviving widow when her husband dies. The couple's results depend on their respective earnings. If one worker has very high and the other very low earnings, the results would more closely approximate the situation of the couple with a single-earner.

Recently, I have used Social Security's hypothetical workers to also analyze how tax preferences for private retirement savings through employer-sponsored plans interact with Social Security. I focused on the 1949 birth cohort. In developing my estimates of Social Security contributions and benefits, I focused purely on contributions for retirement benefits and did not include the value of disability benefits in any computations. In calculating the value of the tax preferences to employer-sponsored retirement plan accumulations, I assumed the alternative investment option would be through a government bond investment account where the contributions would be made with earnings that were taxed in the year earned and the interest accruals each year were subject to income taxes. There are clearly investment options available to workers where the tax effects on savings would not be as significant as this example but I wanted to shed the best possible light on the preferences accorded workers under the tax code.[5]

The examples developed suggest that many of the people who do not have particularly good economic prospects under Social Security can expect to benefit fairly well with the tax treatment of their retirement savings plans. The combined effects of the two systems are reflected in Table 3.

In way of explanation of the results, consider the "medium earner." The single-earner male will be a net loser to the tune of $80,751 under Social Security but potentially a net gainer to the tune of $63,642 under the private pension system. In combination, he will still come out as a net loser of $17,109. The values of the tax preferences in tax-favored retirement plans for two-earner couples shown here are simply the doubling of the single earner values based on the assumption that both workers in the two-earner couples fall into the same earnings category.

The intent of this exercise was to develop the series of combined values shown in the bottom four rows of the table. They represent the net effects of Social Security and the employer-based retirement systems operating in tandem. The results suggest that the majority of

single male workers covered by both Social Security and an employer-sponsored retirement plan are net investors in the combined retirement system despite the tax benefits attributed to the private savings component. Single female workers fare a bit better in this context, as only the high and maximum earners are net investors in the system.

Table 3: Combined Value Social Security Net Benefit Gains versus Contributions and the Lifetime Net Tax Benefits from a Tax-Qualified Retirement Savings for Hypothetical Workers Born in 1949 and Retiring at age 65 by Earnings Level

Value at retirement date	Low earner	Medium earner	High earner	Maximum earner
Net lifetime Social Security gains				
Single male	$6,950	-$80,751	-$201,020	-$495,462
Single female	26,253	-49,033	-158,615	-448,664
One earner couple	171,299	200,429	164,036	-108,378
Two earner couple	52,506	-98,066	-317,230	-897,328
Value of the tax preference in tax-favored				
retirement plan -- one earner	17,185	63,642	152,014	433,604
For two earners	34,371	127,284	304,028	867,209
Combined value of Social Security gains				
plus pension surplus from tax preference				
Single males	$24,135	-$17,109	-$49,006	-$61,858
Single females	43,438	14,609	-6,601	-15,060
One earner couple	188,484	264,071	316,050	325,226
Two earner couple	86,877	29,218	-13,203	-30,119

Source: Sylvester J. Schieber, *The Predictable Surprise, the Demise of the 20th Century Retirement System and the Way Forward* (New York: Oxford University Press, forthcoming in 2012), Chapter 24.

According to the estimates from the Social Security actuaries, a high earner retiring in 2008 had a lifetime average indexed annual earnings level of around $65,000, a level that many might consider to be solidly in the middle class. The two-earner couples' results are simply double the single female results. The ratio of their lifetime Social Security benefits to lifetime contributions is almost exactly the same as that of the single female outcome and their lifetime tax benefits from the employer-sponsored component of the system are identical for both members of each married couple by assumption in developing the earnings and contribution histories.

The one group in all of this that appears to have won the retirement lottery is the couple with only one-earner. The result in this case is being driven by the structure of Social Security and has virtually nothing to do with the employer-sponsored retirement system. The tax benefits for the single earners participating in employer-sponsored retirement plans are exactly the same at every earnings level as those of the one-earner couples so it cannot be these benefit that are

resulting in the tremendous advantage the latter have in the combined systems. It is solely driven by the larger net benefits paid to one-earner couples by Social Security.

The results of this analysis suggest that some workers participating in Social Security receive extremely preferential nonworking spousal benefits under Social Security. This benefit may have made sense in the 1930s or 1940s when most women were homemakers raising children but it makes no sense in an economy where the vast majority of women enter the labor market at an early age and remain there for relatively full careers. In 1944, 11.6 of the retirees claiming a benefit in their own right were women—a clear sign of the predominance of men in the workforce in the era. Labor force patterns changed in the years after World War II and by 1960, 35 percent of the retired workers drawing Social Security benefits were women.[6] By 2008, only 28 percent of the women receiving a Social Security benefit were drawing benefits purely on the basis of the earnings record and entitlement of their husbands.[7]

A growing body of research in recent years has focused on the distributional outcomes under Social Security. In part, these studies have been motivated by concerns over whether stated policies are working as intended. As it has become more apparent that we need to revisit Social Security financing policy, it makes sense to assess whether the program is accomplishing what policymakers had intended in the first place.

Alan Gustman and Tom Steinmeir have analyzed the Health and Retirement Study population in regard to their Social Security benefits relative to their contributions to the system. They conclude:

> When families are arrayed according to the total lifetime earnings, and spouse and survivor benefits are taken into account, the extent of redistribution from families with high lifetime earnings to families with low lifetime earnings is roughly halved. Much of the remaining redistribution is from families where both spouses spend much of their potential work lives in the labor market, to families where a spouse, often with high earnings potential, chooses to spend a significant number of years outside of the labor force. When families are arrayed by their earnings potential, that is, earnings during years when both spouses are engaged in substantial work, there is very little redistribution from families with high to low earnings capacity.[8]

Jeffrey Brown, Julia Coronado and Don Fullerton use a completely different data set, the Panel Study of Income Dynamics, to analyze the same issue. They used data for the years 1968 through 1993, and included all households that had been in the sample for at least 10 of the 26 years and were under age 55 in 1968. They studied the results from more than 6,000 respondents with some over-representation of lower-income individuals. They concluded that

> … when evaluated using potential labor earnings at the household level (rather than actual individual earnings), the Social Security retirement program exhibits virtually no overall impact on inequality... We find that the lack of impact on overall inequality is largely driven by the lack of impact across the middle and upper part of the income distribution, whereas most of those in the bottom income quintile may, in fact, still get net benefits from the program. Third, even when redistribution does occur, we find that it

is not efficiently targeted, with many high income households receiving net transfers, while many low income households pay net taxes.[9]

On at least a dozen separate occasions since the passage of the Social Security Act in 1935, the Congress has explicitly specified a benefit formula meant to deliver progressively higher benefits relative to earnings at lower earnings levels. In the recent recommendations for Social Security reform by both the National Commission on Fiscal Responsibility and Reform and the Debt Reduction Task Force this feature of Social Security would be accentuated to a greater degree than it ever has been historically. Congressman Paul Ryan's Social Security reform proposal in his *Roadmap for America* also calls for enhancing benefits for lower earners and scaling them back at higher earnings levels. Yet we cling to an antiquated benefit that totally defeats what we have told the American public is our national policy.

A Modernizing Addition Worthy of Consideration

Another change to the benefit structure that should be considered in modernizing Social Security is the introduction of a true joint and survivor benefit for married couples. The operation of the spousal benefit partially covers this void but by perpetuating its inequitable existence and mitigating the need for a joint and survivor benefit existing policy propagates another inequity. The longest living spouse in a two-earner couple receives little or no benefit in consideration of the deceased spouse's income and participation in Social Security. This makes the spousal benefit in single-earner couples and even more glaring inequity in the 1939 benefit design to which we are still hitched.

The Retirement Equity Act of 1983 required that private employer-sponsored pensions offer a joint and survivor benefit and the only way that it can be waived is by both spouses signing an affidavit that they do not want such a benefit. These benefits can be self-financing at a moderate cost to the initial annuity and modest effect on the total income adequacy of retirees. Implementing a 100 percent joint and survivor benefit for couples where one spouse has limited or no covered earnings will provide as much protection as the current survivor system and a minimum 50 percent J&S benefit where both have substantial benefits of their own would likely have a positive marginal effect on survivors' income prospects. It is time to bring the same sorts of protections mandated on private pension plans to Social Security. There is no reason we should not modernize the program where it makes sense to do so.

Social Security Policy in a Larger Context

Proposals from both the National Commission on Fiscal Responsibility and Reform and the Debt Reduction Task Force would raise the level of earnings subject to the payroll tax and reduce benefits for higher earners. They also call for dramatically reducing the level of earnings on which tax favored contributions can be made through employer-sponsored retirement plans. The proposal is that participants be limited to tax deductible contributions of the lesser of 20 percent of earnings each year or an annual limit of $20,000. This means that workers earning above $100,000 per year are going to be limited once again in terms of being able to accumulate sufficient resources to provide income replacement in retirement that allows them to maintain their preretirement standard of living. The people that will be most affected by this policy, if it is

implemented, are those with earnings in the $100,000 to $250,000 earnings ranges. This is exactly the same group on whom they propose raising payroll taxes and cutting back Social Security benefits. Adoption of these proposals will make the Social Security results in Tables 2 and 3 much worse for higher earners. This may be an inevitable outcome in any event but I believe it would be a more equitable one if the workers affected are given the opportunity to "earn" back a portion of the tremendous investment they will be making in Social Security by their own retirement savings in a tax favored form.

The reduced tax preferences proposed for retirement savings plans might not mean that many employers will shut down existing programs but it likely portends that some, maybe many, will scale back benefits—namely matching contributions for workers up and down the earnings spectrum as plans are realigned for the meager benefits that can be funded for mid-level managers and technical staff. Tracking the changes that have occurred in employer-based segments of the retirement system over the past 30 years should serve as sufficient warning that regulatory changes do have implications on the evolving structure and levels of benefits that employers offer. If short-term federal revenue considerations lead us to reduce tax expenditures related to retirement savings and it results in long-term demands for increased taxing and expenditures under Social Security, effectively we will have played a game of double jeopardy with future generations.

Endnotes

[1] Robert M. Ball, Oral History found at: http://www.socialsecurity.gov/history/orals/ball6.html..

[2] Robert J. Myers, "History of Replacement Rates for Various Amendments to the Social Security Act," Memorandum no. 2 (Washington, D.C.: National Commission on Social Security Reform, 1982), p. 3 and 1994-1996 Advisory Council on Social Security background materials.

[3] Michael Clingman, Kyle Burkhalter, Alice Wade, and Chris Chaplain, "Money's Worth Ratios under the OASDI Program for Hypothetical Workers," *Actuarial Note* (Social Security Administration, Office of the Actuary, July 2010), no. 7, found at: http://www.socialsecurity.gov/OACT/NOTES/ran7/index.html.

[4] John Geanakoplos, Olivia S. Mitchell, and Stephen Zeldes. "Social Security Money's Worth". *In Prospects for Social Security Reform*, eds. O.S. Mitchell, R. Myers, & H. Young. Philadelphia, PA: Univ. of Pennsylvania Press, 1999: 79-151.

[5] The details of my calculations will be presented in Sylvester J. Schieber, *The Predictable Surprise, the Demise of the 20th Century Retirement System and the Way Forward* (New York: Oxford University Press, forthcoming in 2012), Chapter 24.

[6]Social Security Administration, *Social Security Bulletin, Annual Statistical Supplement, 2008*, Table 5.b5.

[7] Social Security Administration, *Social Security Bulletin, Annual Statistical Supplement, 2008*, Table 5.A14.

[8] Alan L. Gustman and Thomas L. Steinmeier, 'How Effective Is Redistribution under the Social Security Benefit Formula,' (Cambridge, MA: National Bureau of Economic Research, 2000), Working Paper No. 7597.

[9] Jeffrey R. Brown, Julia Lynn Coronado and Don Fullerton, "Is Social Security Part of the Social Safety Net?" (Cambridge, MA: National Bureau of Economic Research, 2009), Working Paper No. 15070, p. 4.