

Measuring Changes to Social Security Benefits

A number of recent proposals to reform Social Security call for changes in the program's benefits. The effects of those proposals are frequently illustrated by comparing the new benefits to those expected to arise under the policies put in place by current law—showing whether they would be higher or lower and by how much. However, because of scheduled changes in benefit rules, a growing economy, and improvements in life expectancy, the benefits prescribed under current law do not represent a stable baseline. Their value will vary significantly across future age cohorts. Thus, focusing on differences from current law will not fully portray the effects of proposed benefit changes. For example, a policy to reduce benefits for future recipients by 10 percent suggests that benefits would be lower than they are today. However, if benefits would double under current law, a 10 percent cut would still render greater benefits for future recipients. Understanding the implications of benefit changes requires an understanding of how the value of benefits would evolve over time.¹

A number of different measures can be used to assess value. One is the percentage of a worker's past earnings that his or her first-year benefits represent—what pension experts refer to as a replacement rate. Replacement rates for current and future retirees show how the program's role as a source of retirement income would change over time. A second measure—the value of first-year benefits adjusted for inflation—illustrates how much the purchasing power of benefits would change from one cohort to the next. A third measure—the value of expected lifetime benefits—indicates how the aggregate benefits of successive generations would com-

pare one to another. Benefits under a proposed reform could be lower when measured by the extent to which they replaced earnings and by their purchasing power but could still be greater than current benefits when tallied over longer expected lifetimes.

When presented along with estimates of how much current-law benefits would be changed, measures showing changes over time in replacement rates, the purchasing power of benefits, and aggregate lifetime benefits provide a more complete picture of how a modified Social Security program would contribute to the income of future retirees.

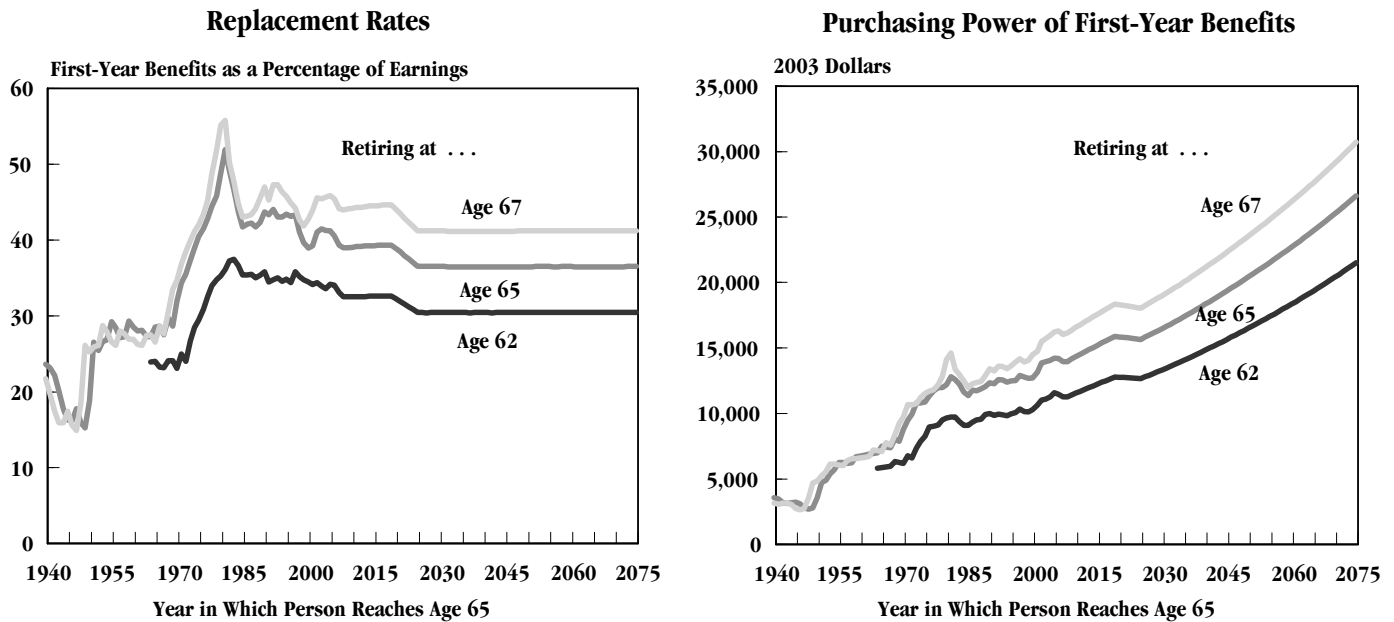
Replacement Rates and the Purchasing Power of Benefits

Largely as a result of modifications legislated over the years, the proportion of a worker's average career earnings that Social Security benefits replace has not been the same from one cohort of recipients to the next. During the program's first decade (1940 to 1950), replacement rates generally fell for each cohort of new retirees.² They rose in 1950 with a major increase in benefits and then hovered in a relatively narrow range for the next 20 years. Following a series of benefit increases and program reforms in the late 1960s and early 1970s, they rose again, reaching a historical peak in 1980 at levels more than twice as high as when the program began. Major reforms enacted in 1977 caused replacement rates to recede somewhat in the 1980s, after which they leveled out. Additional reforms enacted in 1983—raising the age for receiving full benefits—will cause them to

1. This brief focuses on alternative measures of changes in benefits. A discussion of the overall value of the Social Security system would consider both benefits and taxes.

2. The replacement-rate concept used here shows first-year benefits expressed as a percentage of average career earnings adjusted for wage growth in the economy up until the year before retirement.

Figure 1.
Two Measures of the Value of Initial Social Security Benefits



Source: Congressional Budget Office based on the intermediate projections from Social Security Administration, *The 2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 17, 2003).

Notes: Amounts are based on careers approximating those of workers who steadily earned an average wage.

Social Security retirement benefits can be paid beginning at age 62 (as authorized for women in 1956 and for men in 1961).

recede again over the next two decades.³ Replacement rates will typically drop by 10 percent to 12 percent before stabilizing at lower levels. (See Figure 1.)

At the same time, because Social Security benefits are based on career earnings and earnings in the economy rise over time—at a rate generally in excess of inflation—the first-year benefits for successive groups of new recipients are projected to rise in terms of the goods and services that they will buy. For average earners retiring at age 65 in 2035, the purchasing power of their first-year benefits is projected to be \$17,000 (in 2003

dollars)—25 percent greater than that for a comparable retiree today.⁴ (See Figure 1.)

Thus, by one measure, future Social Security benefits would be smaller than they are today, and by another measure, they would be larger.

Life Expectancy

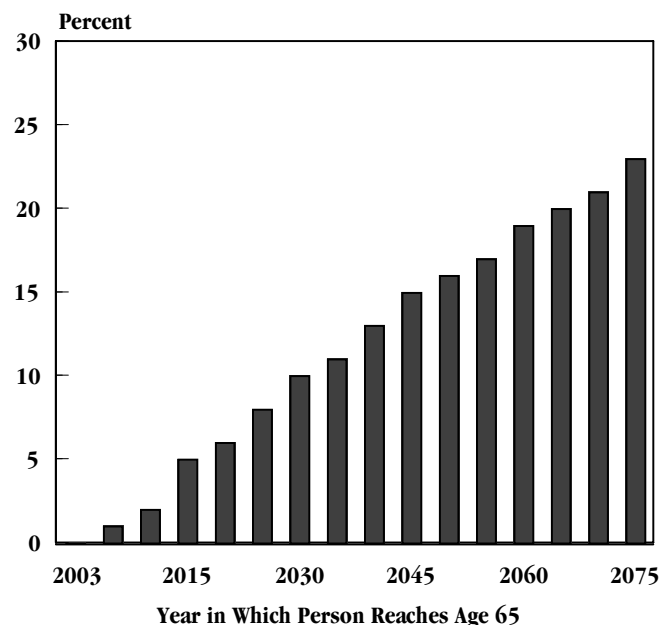
As with the two previous measures, the value of current-law Social Security benefits paid over a lifetime has not been, and is not projected to be, a stable benchmark. Increasing longevity boosts lifetime benefits.

Under current demographic assumptions, people reaching age 65 in 2003 can expect to live, on average, until age 83. That life span is four and a half years longer than it was for people who reached age 65 in 1940. By

3. The age at which a person may receive full benefits, or what the law refers to as the retirement age, is scheduled to rise from 65 in 2002 to 67 in 2027. The earliest age at which one becomes eligible for retirement benefits will remain at age 62, but workers retiring “early” will face larger reductions in monthly benefits, and as the retirement age increases, workers retiring at ages 65 and 66 will be considered to be retiring early and will have to take partial reductions.

4. See Congressional Budget Office, *The Future Growth of Social Security: It’s Not Just Society’s Aging*, Long-Range Fiscal Policy Brief No. 9 (July 1, 2003).

Figure 2.
Increase in Life Expectancy at Age 65 from 2003 to 2075



Source: Congressional Budget Office based on the intermediate projections of life expectancy by cohort in Social Security Administration, *The 2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 17, 2003).

2035, life expectancy could extend two more years, to age 85. On the basis of that trend (as shown in Figure 2), a 65-year-old retiree in 2020 could expect to get 14 more months of benefits than a 65-year-old retiree today; a retiree in 2035 could get two more years of benefits; and a retiree in 2075, more than four more years' worth. That increase of more than four years amounts to a 23 percent longer period of receiving benefits.

Presenting a More Complete Picture

As illustrated here, current benefit policy should not be mistaken for constant benefit levels. Under current law, the benefits for successive groups of future retirees are projected to decline as a share of past earnings but to rise when gauged by their purchasing power or the lengthening lifetimes over which they will be received. For that reason, a proposed reduction in the Social Security program's overall future costs does not necessarily mean a

Table 1.
Illustrative Impact of a 10 Percent Reduction in Benefits

	People Reaching Age 65 and Retiring in		
	2003 Under Current Law	2035 Under Current Law	2035 with a 10 Percent Cut
Replacement Rate (Percent) ^a	41	36	33
First-Year Benefits (Dollars) ^b	13,800	17,200	15,500
Present Value of Lifetime Benefits (Dollars) ^b	193,000	260,000	234,000

Source: Congressional Budget Office based on the intermediate projections from Social Security Administration, *The 2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 17, 2003).

Note: This presentation rests on various assumptions—about factors such as inflationary trends, workers' productivity, interest rates, and life expectancy. Varying those assumptions could produce different projections of benefits.

- a. First-year benefits as a percentage of average career earnings.
- b. Inflation-adjusted; amounts are based on careers approximating those of workers who steadily earned an average wage.

reduction in the value of benefits for future recipients relative to the value for people today.

For example, suppose that a 10 percent reduction in benefits was enacted for future retirees as a way to reduce the program's costs. For average earners retiring at age 65, the reduction would cause replacement rates to drop to 33 percent in 2035, compared with 41 percent today and a projected 36 percent in 2035 under current law (see Table 1).⁵ However, because new benefits for

5. If the program afforded constant replacement rates over time, a 10 percent reduction in benefits would result in a 37 percent replacement rate for average earners retiring at age 65 in 2035. But because that reduction would be in addition to reductions arising from the increase in the retirement age already scheduled under current law, the replacement rate for retirees in 2035 would be 33 percent.

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future retirees are projected to grow faster than inflation, even with that reduction, the purchasing power of the benefits for retirees in 2035 would be 12 percent greater than it is for people retiring today. Moreover, because retirees in 2035 are projected to live two years longer, their lifetime benefits would be more than 20 percent greater.

Because of the numerous complexities involved, no single baseline or reference measure adequately captures how a proposal would change the Social Security benefits paid to future recipients. Therefore, recognizing how a proposal would alter the relative value of future benefits—

not just how benefit levels would differ from those under current law—is critical to assessing its potential consequences.

Related CBO Publications: *The Future Growth of Social Security: It's Not Just Society's Aging*, Long-Range Fiscal Policy Brief No. 9 (July 1, 2003); and *Social Security: A Primer* (September 2001).

This policy brief was prepared by Dave Koitz. It and other publications by CBO are available at the agency's Web site (www.cbo.gov).

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