# President's Privatization Plan
# Cuts Social Security Checks By
# $162,058 for a Typical Wisconsinite

Deeper cuts for those who wish to leave any private account income to their spouse.

In a press conference on April 28, 2005, President Bush announced new details about his plan to change Social Security. The plan has two components: mandatory benefit reductions for nearly all American workers and optional private accounts which would reduce guaranteed benefits even further for workers who choose an account. Contrary to many news reports, and claims by proponents of privatization, the President's proposal would actually leave the typical American worker with less than Social Security provides today and according to a new analysis by the Center on Budget and Policy Priorities, the President's plan would close only 30 percent of the total Social Security shortfall over the next 75 years.[1]

This report shows the reductions in Social Security benefits that a typical Wisconsinite can expect to see because of the President's Social Security proposal. The findings are based on the latest details available about the President's plan, typical wages for Wisconsin workers, estimates by the non-partisan Congressional Budget Office on the long-term effects of various Social Security reform proposals, and calculations by the Institute for America's Future and the Center for Economic and Policy Research.

The President's plan includes mandatory cuts to guaranteed Social Security checks for nearly all workers who earn over $20,000 per year, regardless of whether or not the worker chooses a private account. If a worker does choose to participate in a private account, their guaranteed benefits would be reduced by an additional amount and the private account would be expected to make up the difference. Depending on an individual's income history and private account investment performance, some workers may find themselves left with benefit cuts even deeper than the mandatory cuts prescribed by the President's plan simply because they chose to participate in the President's private account plan.

Under the President's plan, a typical Wisconsin worker who chooses a private account and retires in the year 2080 – the final year of Social Security's 75 year planning horizon – would see a lifetime benefit cut of $162,058 in today's dollars.[2] This is the benefit cut a Wisconsinite would suffer even ***after*** accounting for earning an average 4.35 percent return on their private account investment.[3]

Under current law, the same worker can expect a total lifetime Social Security benefit of $688,133 (2005 dollars). If a worker chooses not to participate in one of President Bush's private accounts, his plan calls for mandatory cuts to guaranteed Social Security checks for nearly all workers – fully $178,459 over their lifetime. This report also shows that benefit cuts increase over time – first cutting benefits for today's baby boomers, becoming more severe for today's young workers, becoming worse for today's children, and are most severe for America's next generation.

The report also finds that many of the key aspects of the President's plan touted by the White House would actually increase the severity of the benefit cut. Benefit cuts increase if a worker wants their spouse to continue receiving benefits from the private account after the worker dies or if a risk-averse worker wishes to invest only in bonds, for example.

It is important to note that this report describes the Social Security retirement benefit cuts that a typical Wisconsin worker would see under the President's plan. The President's plan also includes reductions to Social Security benefits for widows, widowers and children who have lost a parent. These benefit cuts will impact women more than men as women benefit from these important aspects of Social Security than men do. Advisors to the President have also said that benefits for Americans with disabilities will also be changed. While this analysis does not calculate the benefits lost for surviving spouses and children nor for people with disabilities or their families, a consideration of these important benefits is necessary for a full evaluation of the President's Social Security proposal.

## Mandatory Benefit Cuts for Nearly All Wisconsin Workers

The mandatory benefit cut portion of President Bush's proposal is based on a plan articulated by investment manager Robert Pozen.[4] These cuts would change the growth formula for guaranteed Social Security benefits. Depending on a worker's income – this change has different effects.

Guaranteed benefits for those earning $90,000 a year or more (2005 dollars) would only rise in step with inflation rather than with wages, which typically rise faster. Thus, benefits for those very high wage workers would be frozen in real terms (after accounting for inflation) under the President's plan. Growth of guaranteed benefits for those now earning between about $20,000 and $90,000 would be slowed using a new formula based on a mix of wage and price indexing depending on one's income history and the date of their retirement. Most workers under age 65 today would receive lower guaranteed benefits under President Bush's plan than they are now promised by current law. This cut increases with severity over time as wages increase faster than prices, leaving future retirees with deep cuts compared to the benefits that today's retirees depend on.

To see how this works, imagine a 20 year-old today who enters the labor force this year and earns the national average wage in a typical year over the course of their work life (approximately $36,500 in 2005). According to the projections of the Congressional Budget Office, if this worker retires at age 65 in 2050, he or she would receive a Social Security retirement benefit equal to about $22,000 annually (in 2005 dollars). On average, this worker can expect to collect benefits for 20.9 years, which means that his or her total guaranteed Social Security retirement benefit would be $460,000 (in 2005 dollars).[5]

Under President Bush's plan, the growth in benefits for this worker would be indexed to a combination of prices and wages. Assuming that President Bush's plan takes effect in 2012, this would mean that the worker would only get 80.5 percent of the benefit promised to them under current law. His or her lifetime benefit under President Bush's plan would therefore be $370,000, or $90,000 less than the scheduled benefit (in today's dollars). This is the cut this worker would face without a private account.

To examine the full effects of the President's plan, it is necessary to look at the next generation of Americans – who are impacted even more severely. Under the President's plan, a worker born in 2014 and retiring at age 67 would see deeper cuts. It is important to examine the effects of the plan on workers retiring in the year 2080 because this is the last year of the 75 year planning horizon used by experts, including the White House and Social Security Administration actuaries, to assess various reform proposals and Social Security's overall fiscal outlook.

In Wisconsin, the typical annual salary is approximately $32,464.[6] The Social Security Administration estimates that a worker retiring in 2080 can expect to live 20.4 years after retirement.[7] **A Wisconsin worker earning the typical wage in the state would see a mandatory benefit cut of $178,459, regardless of whether or not they choose a private account.** The remaining lifetime retirement benefit of $509,674 pales in comparison to the $688,133 that is promised by Social Security under current law.[8]

## Additional Benefit Cuts For Those Who Choose Private Accounts

President Bush's plan would also allow workers the option of diverting up to 4 percentage points of their payroll taxes into one of several private investment portfolios that the federal government has authorized you to choose from.[9] These investment portfolios would be managed by private companies and would have varying degrees of risk and potential returns.

Unfortunately, the President's plan would not allow private account holders to keep all of their earnings on top of what those not choosing a private account could expect from Social Security. Under the Bush plan, the government would reduce the guaranteed Social Security benefits of private account holders by an amount deeper than the mandatory benefit cut (described above) that they would already be subject to.

The amount of this additional benefit cut is equal to the amount an individual has *contributed* to the private account plus 3.3 percent interest. Under the President's proposal, our Wisconsin worker retiring in 2080 would see his or her guaranteed Social Security retirement benefit reduced to $ 864 per month and their lifetime guaranteed benefit would drop to $211,507. **This worker's guaranteed Social Security benefit would be reduced by a whopping $476,626 from the benefit guaranteed by current law.[10]**

## $162,058 In Benefit Cuts Even After Considering Private Account Earnings

If our typical Wisconsin worker, retiring in 2080, placed the maximum dollars possible into a private account each year and obtained an average rate of return that is consistent with the economic projections of the CBO,[11] this worker's account assets would reach a total amount of $266,385 at retirement after deducting the 0.3 percent administrative fees assumed by CBO[12] (2005 dollars).

Social Security currently provides American workers, who have paid into the system, with inflation guaranteed retirement benefits for life. This is important because many individuals would otherwise outlive their savings because they are fortunate enough to live a long life or because they spent their savings early on a healthcare emergency or a trip to Las Vegas.

As shown above, the President's plan cuts guaranteed benefits dramatically if an individual chooses a private account. To ensure that the very old do not find themselves living below the poverty line, the President's plan requires an individual to purchase an annuity with any earnings from their private account if that is necessary to keep them above the poverty line. Depending on the terms set by the annuity company, the annuity would pay the worker a steady income every month based on their starting account balance.

Experts estimate that an annuity that would guarantee a lifetime of payments for our Wisconsin worker to cost approximately 5 percent of the private account starting balance in fees to the annuity company.[13]

When the annuity is added to their guaranteed Social Security benefit, a typical Wisconsinite who chose a private account could expect to receive a lifetime benefit of $526,075 over the course of their 20.4 year life expectancy at retirement. **After average gains from private accounts are added to guaranteed benefits, our typical Wisconsinite would see a cut of $162,058 from the Social Security retirement benefits promised by current law.[14]**

However, investments in the stock market are inherently risky, and there is no guarantee that this worker would obtain the average return. Additionally, the annuity payments described above would cease immediately upon the death of this worker. Workers who wished to ensure that their surviving spouse continued to receive annuity payments after the primary wage earner's death would face much higher annuity fees, further reducing the value of the private account.[15]

## President's Plan Cuts Benefits Regardless of Market Performance

The President has said that workers who are risk averse can choose to invest their private accounts solely in bonds. In this scenario, the worker would receive only a 2.97 percent return (above inflation) on their investment. This amount of return could also hit a worker if, for example, there was a market downturn in the years before she retired.

In this "worse" case, our Wisconsin worker would retire with a private account worth $225,432. After fees are deducted and a single individual annuity is purchased, **this worker could expect a lifetime retirement benefit of $478,339 or $209,794 less than promised by current law and even less than if she did not choose a private account at all if their investment yields less than average returns.[16]**

It is also necessary to examine a "best" market performance scenario. Assuming that a worker received a 6.8 percent return on their private account, this worker would still find themselves with benefit cuts. This could not be the average return for many workers, since it would require that the price-to-earnings ratio, which historically has stood at 15, would rise to an astonishing 440 by the year 2080.[17]

In this "best" case, our typical Wisconsin worker would retire with an account worth $363,306. After fees are deducted and a single individual annuity is purchased, **this worker could expect a lifetime retirement benefit of $638,683 or $49,450 less than promised by current law even with "best" case returns on their investment.[18]**

## Deeper Benefit Cuts Required To Make Private Account Inheritable

The figures above are dependent on annuity payments stopping with the death of the single purchaser of the annuity. If a couple wanted the surviving spouse to continue receiving income from the annuity after the first spouse died, the annuity costs would increase significantly.[19]

Many couples who opt for a private account will choose to purchase such a joint or "dual life" annuity to ensure that both spouses would continue to receive checks after the first spouse dies. These annuities are significantly more expensive, since the companies insuring the annuity must anticipate the increased likelihood that one spouse will be relatively long-lived, thus increasing the likelihood of less profit for the annuity company. Such annuities are likely to cost approximately 20 percent of the initial private account balance.[20]

To see the implications of these costs, let's return to our 20 year-old worker, retiring in 2080 and earning the average wage in Wisconsin state. As we saw, purchasing an annuity for himself, he would receive a total lifetime retirement benefit of $526,075. If this worker wanted to purchase a "dual-life" annuity for him and his spouse after earning average returns on their investment, they would only receive a benefit of $476,381. **The cost of making the President's private accounts inheritable is high – workers could expect to see a benefit cut of $211,752 from what current law promises.[21]**

Annuity companies offer many different options for their clients. Generally, if the annuity company expects to be able to keep more of a client's private account balance in the form of profit, initial costs to the client are lower. If the company anticipates an increased likelihood that they will keep less of a client's initial account balance, client costs rise. Under the scenario described above, annuity payments would stop once both spouses have died – no assets could be left to heirs.

A worker who wished to purchase an annuity for him or herself and leave a cash balance to heirs upon their death, would require an entirely different set of annuity costs if such a product is even available.[22] According to the National Academy of Social Insurance, "an inherent tension exists between the interests of heirs and the purchase of annuities because money used to buy a life annuity is no longer available to leave to heirs."

The typical Wisconsinite would suffer severe retirement benefit cuts with the President's plan regardless of how the stock market performs and regardless of whether an individual chooses an individual account at all. The plan only closes 30 percent of the Social Security system's financial shortfall and actually worsens the short term health of the system according to the non-partisan Center on Budget and Policy Priorities.[23]

The findings of this analysis beg the question: who benefits from the President's privatization proposal?

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**End Notes**

[1] Center on Budget and Policy Priorities, "Why the President's Social Security Plan Closes Just 30 Percent of the Long-Term Shortfall," May 13, 2005. Available online at http://www.cbpp.org/policy-points5-13-05.htm.

[2] Social Security Administration, "2005 OASDI Trustees Report," March 23, 2005. According to the 2005 Social Security Trustees Report, the average life expectancy for a person age 65 in the year 2080 is 22.4 years. Because the retirement age will reach 67 by 2027, the Institute for America's Future subtracted two years from the average life expectancy for and assumed retirement age of 67 in 2080. Therefore, all lifetime benefit calculations are based on a 20.4 years of life after age 67. Source available online at http://www.ssa.gov/OACT/TR/TR05/. Using those life expectancy assumptions calculations for this report were made using the Center for Economic and Policy Research's Accurate Benefits Calculator (http://www.cepr.net/calculator/calculator.html). The Institute for America's Future aggregated the monthly totals provided by the Center for Economic and Policy Research to derive lifetime totals described in this report.

[3] The stock return consistent with Congressional Budget Office (CBO) projections and a steady price-to-earnings ratio is 4.35 percent. Following CBO, this analysis assumes a portfolio consisting of 50 percent stocks, 30 percent private bonds and 20 percent Treasury bonds. The total real return from such a portfolio would be 3.97 percent before fees.

[4] Charles Stein, "Pozen's Social Security fix sparks buzz: Plan would combine investment accounts, selective benefit cuts," *Boston Globe*, March 17, 2005.

[5] Social Security Administration, "2005 OASDI Trustees Report," March 23, 2005. According to the 2005 Social Security Trustees Report, the average life expectancy for a person age 65 in the year 2050 is 20.9 years. Source available online at http://www.ssa.gov/OACT/TR/TR05/. Using those life expectancy assumptions calculations for this report were made using the Center for Economic and Policy Research's Accurate Benefits Calculator (http://www.cepr.net/calculator/calculator.html). The Institute for America's Future aggregated the monthly totals provided by the Center for Economic and Policy Research to derive lifetime totals described in this report.

[6] Bureau of Labor Statistics, Quarterly Census of Employment and Wages, Table 1: Average Annual Wages for 2001 and 2002 for all Covered Workers by State. Available online at www.bls.gov/cew/state2002.pdf. The latest data available for state averages is 2002.

[7] Social Security Administration, "2005 OASDI Trustees Report," March 23, 2005. According to the 2005 Social Security Trustees Report, the average life expectancy for a person age 65 in the year 2080 is 22.4 years. Because the retirement age will reach 67 by 2027, the Institute for America's Future subtracted two years from the average life expectancy for and assumed retirement age of 67 in 2080. Therefore, all lifetime benefit calculations are based on a 20.4 years of life after age 67. Source available online at http://www.ssa.gov/OACT/TR/TR05/.

[8] To calculate the lifetime Social Security benefit under the president's plan (without a private account) as well as with the current law, the yearly benefit was multiplied by the average life expectancy for a person age 67 in 2080 (20.4 years).

[9] White House, "Strengthening Social Security for the 21st Century," February 2005. Available online at http://www.whitehouse.gov/infocus/social-security/200501/strengthening-socialsecurity.html.

[10] See note #2 above for citation and methodological explanation.

[11] The stock return consistent with CBO projections and a steady price-to-earnings ratio is 4.35 percent. Following CBO, we assume a portfolio consisting of 50 percent stocks, 30 percent private bonds and 20 percent Treasury bonds. The total real return from such a portfolio would be 3.97 percent before fees.

[12] Calculations for this report were made using the Center for Economic and Policy Research's Accurate Benefits Calculator (http://www.cepr.net/calculator/calculator.html).

[13] A five percent annuitization fee was applied in calculating the amount of private account balance lost when an individual purchases a single life monthly annuity. This charge is attributable to the administrative costs of this transaction. O.J. Mitchell, et al, "New Evidence on the Money's Worth of Individual Annuities." American Economic Review, December 1999; as cited in the Center for Economic and Policy Research's Accurate Benefits Calculator (http://www.cepr.net/calculator/calculator.html).

[14] See note #2 above for citation and methodological explanation.

[15] Virginia Reno and Joni Lavery, "Social Security: What Role for Life Annuities in Individual Accounts? Issues, Options, and Tradeoffs," National Academy of Social Insurance; Issue Brief No. 19, March 2005. Available online at http://www.nasi.org.

[16] See note #2 above for citation and methodological explanation.

[17] Dean Baker, "Bush's Numbers Racket," The American Prospect. February 1, 2005

[18] See note #2 above for citation and methodological explanation.

[19] For more about the various kinds of individual and joint annuities that are available see Virginia Reno and Joni Lavery, "Social Security: What Role for Life Annuities in Individual Accounts? Issues, Options, and Tradeoffs," National Academy of Social Insurance; Issue Brief No. 19, March 2005. Available online at http://www.nasi.org.

[20] A twenty percent annuity fee was applied in calculating the amount of private account balance lost when an individual purchases an annuity with the right of survivorship. The dual-life annuity pays a monthly benefit to the primary spouse for the duration of their life and, upon death, passes to the surviving spouse. This annuity is *not* – in turn – passed on to surviving children. The monthly annuity benefit for a couple is estimated to be 80 percent of a single life annuity. Center for Economic and Policy Research's Accurate Benefits Calculator (http://www.cepr.net/calculator/calculator.html).

[21] See note #2 above for citation and methodological explanation.

[22] Virginia Reno and Joni Lavery, "Social Security: What Role for Life Annuities in Individual Accounts? Issues, Options, and Tradeoffs," National Academy of Social Insurance; Issue Brief No. 19, March 2005. Available online at http://www.nasi.org.

[23] Center on Budget and Policy Priorities, "Why the President's Social Security Plan Closes Just 30 Percent of the Long-Term Shortfall," May 13, 2005. Available online at http://www.cbpp.org/policy-points5-13-05.htm.