BUDGET BULLETIN
SENATE COMMITTEE ON THE BUDGET
CHAIRMAN MIKE ENZI | @BUDGETBULLETIN

114th Congress, 1st Session: No. 9 October 6, 2015

Focus on Social Security Replacement Rates

In This Issue:
Primer on Replacement Rates
Two Views of Replacement Rates
Policy Choices Considered
Action Needed to Secure Future

by Steve Robinson, Senior Budget Analyst

Primer on Replacement Rates

Social Security provides monthly cash benefits to retired and disabled workers, as well as their eligible spouses, dependents, and survivors. The current benefit formula, enacted by Congress in 1977, was first applied to individuals born in 1917, who turned 62 in 1979. To evaluate the adequacy and equity of this formula, benefits are often compared with wages. The ratio of benefits to wages, known as the replacement rate, reflects the extent to which benefits replace the wages lost due to retirement, disability, or death. The higher the ratio, the easier it is for workers to maintain their standard of living after they become eligible for benefits.

Replacement rates provide a useful way to assess the relative value of benefits, provided they are presented in a clear and consistent manner. These rates as typically presented by the Social Security Administration (SSA), however, have been subject to criticism focused on SSA's use of career-average, wage-indexed earnings as the denominator in their calculations, resulting in the rates' removal from the 2014 and 2015 annual Social Security trustees' reports.

SSA's choice of a denominator is not the focus of this *Budget Bulletin*, but rather how replacement rates are presented over time, which determines whether replacement rates are seen to be constant or rising. There are two distinct views presented: SSA's traditional view shows replacement rates to be roughly constant over time by comparing workers with different real (inflation-adjusted) wages. The alternative view shows replacement rates generally rising over time by comparing workers with the same real wages.

These differing perspectives highlight the current public policy challenge. Maintaining the future solvency of Social Security requires changes in present law. And yet the use of replacement rates as typically presented conceals the growth in benefits that occurs over time, which affects the public's perception of the policy choices facing Congress and the president.

To better inform the public, this *Bulletin* further explores the two views of replacement rates and their implications for public policy.

Two Views of Replacement Rates

There are two key features of the Social Security benefit formula. First, it is progressive. That means for any given age group, those with lower wages have higher replacement rates. Second, the formula is linked to average wages in the U.S. economy. This linkage, known as the Average Wage Index (AWI), means economic growth tends to increase rates at every given real wage from one age group to the next.

In the below table, the Alternative View section illustrates both these features. Workers earning $12,000 a year have higher replacement rates than workers earning $96,000 a year, no matter when they turn 62. Workers who turn 62 in later decades, however, generally have higher rates than workers with the same real wages who turn 62 in earlier decades.

Two Views of Social Security Replacement Rates at Normal Retirement Age								
Annual Wages	**Year Worker is Age 62**							**Percent Change**
	1979	**1989**	**1999**	**2009**	**2019**	**2029**	**2039**	
Alternative View Real Wages in Constant 2015 Dollars								
$12,000	66%	68%	71%	77%	76%	80%	81%	**+22%**
$24,000	49%	49%	50%	54%	52%	58%	62%	**+26%**
$48,000	38%	39%	40%	42%	40%	43%	45%	**+18%**
$96,000	20%	23%	27%	30%	30%	34%	36%	**+81%**
Traditional View Relative Wages as Percent of Average Wage Index								
25%	79%	77%	75%	79%	70%	73%	73%	**-7%**
50%	55%	53%	52%	55%	48%	51%	51%	**-8%**
100%	43%	42%	41%	43%	38%	40%	40%	**-8%**
200%	27%	28%	28%	31%	27%	29%	29%	**+5%**
Normal Retirement Age (NRA) and Average Wage Index (AWI)								
NRA	65	65	65	66	66.5	67	67	n/a
AWI	$34,997	$38,719	$44,097	$45,654	$55,354	$62,988	$70,756	+102%
Source: Senate Budget Committee, Republican Staff								

The replacement rates shown under the alternative view differ substantially from those typically presented by SSA because the agency assumes each age group earns the same relative, rather than real, wages.

The Traditional View section in the above table adopts SSA's assumption that each age group earns the same percentage of the AWI. The AWI is a proxy for the economy-wide average wage. For any given age group, workers with lower wages relative to the AWI have higher replacement rates. But rates are roughly constant at every relative wage level from one age group to the next. Some variation occurs when the rate of growth in the AWI deviates from its historical trend.

Under the traditional view, workers at 100 percent of the AWI earn between $34,997 for the 1979 age group and $70,756 for the 2039 age group, while they all share a replacement rate of roughly 40 percent. Thus, by equating real wages that are different, this view presents rates as the same.

Policy Choices Considered

In the preceding table, the Alternative View section shows constant real wages and rising replacement rates, while the Traditional View section presents rising real wages and constant replacement rates. These conflicting views require a choice between two policy approaches:

- Provide constant replacement rates for workers who earn the same AWI-relative wages, regardless of how high their real wages grow. Consequently, future taxes would be higher than in the past or present.

- Provide constant replacement rates for workers who earn the same real wages, regardless of how their wages compare with the AWI. Accordingly, future replacement rates would no longer increase at every given real wage.

Choosing between these alternatives involves a value judgment regarding the desired role of Social Security in the future. Historically, the program has been viewed as one part of a multi-tiered income-support system, including public assistance, personal savings, and employer pensions. Social Security's progressive formula complements the other tiers by providing relatively more to those relying on public assistance and relatively less to those with savings, investments, and pensions.

On the one hand, the decision to provide constant replacement rates at constant AWI-relative wages reflects the view that benefits should increase with the nation's standard of living. This view holds that despite a rising standard of living, future workers should rely more on Social Security and less on their own savings and investments when retired.

On the other hand, the decision to provide constant replacement rates at constant real wages reflects the view that a progressive system should not provide higher real benefits to those with higher real wages. This view holds that due to a rising standard of living, future workers will be able to save and invest more for their own retirement, and thus be less reliant on Social Security.

Action Needed to Secure Future

The Social Security disability trust fund will be insolvent by the end of next year. The retirement and survivor trust fund will be insolvent in less than two decades. While that might seem like plenty of time to solve the problem, it all depends on which path the federal government chooses to take. Some solutions are more time-sensitive than others.

The public deserves the opportunity to consider all the options to address Social Security's pending insolvency while there is still time to make a difference. And careful consideration starts with a better understanding of replacement rates and their public policy implications.