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What Could Have Been: How PRAs Would Have Benefited the Baby Boomers

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In this year's State of the Union address, President George W. Bush again pledged to advance the ownership society by introducing personal retirement accounts (PRAs) into Social Security. The President's proposal would allow younger workers the opportunity to deposit part of their Social Security payroll taxes into a PRA, which would be invested in funds similar to mutual funds. Such funds might mimic the federal government's Thrift Savings Program, which allows federal employees a choice of five very broad index funds.

This proposal caused a great deal of consternation among critics. For example, the AARP has taken out full-page ads charging that such reform would be like playing the slots in Las Vegas. Senate minority leader Harry Reid (D–NV) echoed this sentiment in the Democratic response to the State of the Union speech: "[T]he Bush plan isn't really Social Security reform. It's more like Social Security roulette."[1]

If Social Security is designed to be a retirement income program, then it makes sense to evaluate how typical individuals would fare under reform that includes PRAs versus current-law Social Security. Numerous analysts and organizations have already conducted these kinds of simulations.

A more novel question would be: What if President Lyndon B. Johnson had advocated an ownership society in 1964? Would the retirement income of a new retiree in 2005—some 40 years later—be much different from what it is under traditional Social Security?

Talking Points

- Government-run Social Security has been an extremely poor "investment" for workers, who in recent years have sent more than 10 percent of their earnings to the federal government.
- If workers retiring this year had been allowed to put a portion of these payroll taxes into a PRA, their retirement income would be approximately 30 percent higher than it would be under traditional Social Security alone.
- These higher returns from PRAs would more than offset the reduction in traditional Social Security benefits that would typically come with such reform.
- Such "ownership society" reforms would give retirees greater control over their retirement and the option of leaving the additional money to their heirs or charity.

This paper, in its entirety, can be found at:
www.heritage.org/research/socialsecurity/bg1836.cfm

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In fact, such reform would have greatly increased the retirement security of these workers. This analysis, which uses actual historical rates of return on large company stocks and government bonds, comes to the following conclusions:

- New retirees would have higher retirement incomes with PRAs than under current-law Social Security. The monthly retirement income for the average worker would be about 30 percent higher with PRAs.
- This percent change translates into hundreds of dollars per month in additional retirement income.
- These higher incomes more than offset the reduction in traditional Social Security benefits that would typically come with such reform (to eliminate double-dipping).
- Additionally, if retirees did not want to convert all of their PRA wealth into an income stream, they could leave the money to their heirs or charity or could use it for some other purpose.

The PRA Debate

Social Security reform is a highly charged and emotional topic, with advocates and researchers on both sides of the issue debating the costs and benefits of changing the system. On the research side, most of the debate has been over what future retirees could expect in terms of retirement income after reform.

This paper asks a different question: What if a new retiree in 2005 had been able to establish a PRA in 1965? How much retirement income would he or she now receive per month? How would this differ from Social Security benefits under current law?

This approach is novel because, unlike most other research, this analysis uses actual rates of return for stocks and bonds over the course of those 40 years. Since the mid-1960s, the economy has seen a broad array of challenges—six recessions, wage and price controls in the early 1970s, stagflation in the late 1970s, and the bursting of the Internet bubble. Even through these fluctuations, however, the markets appreciated in value, which would have added thousands of dollars of capital to these PRAs by retirement if they had existed 40 years ago.

Methodology and Cases

For this analysis, three representative single workers and three representative dual-earner married couples were profiled. To simplify calculations, all of the hypothetical individuals were born in 1940 and participated in the hypothetical PRA plan for 40 years from 1965 to 2004. The workers differ only in their earnings, which are expressed in real (inflation-adjusted) terms. The low-income, moderate-income, and high-income single workers earned average annual wages of $15,000, $35,000, and $65,000, respectively. The combined earnings for the low-income, moderate-income, and high-income couples were $40,000, $80,000, and $120,000, respectively.[2]

An "age earnings" profile was applied to each worker so that earnings were lower earlier in life and began to plateau when the worker reached his or her early 50s. Similar profiles have been used in previous analyses.[3]

Their PRAs were funded through Social Security payroll taxes on a sliding scale from 2.5 to 7 percentage points based on the worker's earnings level. The lowest earners were able to deposit 7 percent of their earnings into their PRAs. Workers at or

1. Harry Reid (D–NV), "Transcript of Democratic Response to the State of the Union Address," CNN, February 3, 2005, at *www.cnn.com/2005/ALLPOLITICS/02/02/dem.transcript/index.html* (March 18, 2005).
2. In the dual-earner couple earning $40,000, the husband earned $26,000, and the wife earned $14,000. A similar ratio was applied to the $80,000 couple: The husband earned $52,000, and the wife earned $28,000. In the $120,000 couple, the husband earned $66,000, and the wife earned $54,000.
3. For example, see William W. Beach, Alfredo B. Goyburu, Ralph A. Rector, Ph.D., David C. John, Kirk A. Johnson, Ph.D., and Thomas Bingel, "Peace of Mind in Retirement: Making Future Generations Better Off by Fixing Social Security," Heritage Foundation *Center for Data Analysis Report* No. 04–06, September 10, 2004, at *new.heritage.org/Research/SocialSecurity/CDA04-06.cfm*.

above the Social Security earnings cap[4] were able to deposit 2.5 percent into their PRAs. Under this plan, the PRAs were invested in an equally balanced portfolio of large company stocks and government bonds. Chart 1 and Table 1 display the results for each of the six cases.

If PRAs were "carved out" of the Social Security taxes, traditional benefits from the Social Security system would be reduced to prevent the "double-dipping" problem. As a simplifying assumption, traditional Social Security payments for workers opting into PRAs in this simulation would be cut in half. Even with this reduction, all three single workers and all three couples would have been better off with PRAs.

Case 1a: Low-Income Single Worker. Low-income workers potentially have the most to gain through PRAs. Federal Reserve data suggest that these workers will have America's lowest levels of savings and wealth accumulation at retirement, at a little over $20,000.[5] Due to the relatively low earnings level, the single worker earning $15,000 per year would have been able to set aside 6 percent of his or her earnings in a PRA. At retirement, the worker would have a PRA of nearly $111,000, which could be used to purchase an annuity that would provide $640 per month for life.[6] Combined with a reduced traditional Social Security benefit of $419, this would provide the worker with a monthly retirement benefit of $1,058.[7]

Under current law, the low-income worker's Social Security benefits would be only $837 per month. Put another way, if the worker had been able to use a PRA, his or her retirement income would be 26.5 percent higher than under current-law Social Security.

Case 1b: Low-Income Dual-Earner Couple. The couple with total earnings of $40,000 per year would have been able to divert 6.5 percent of the wife's earnings and 5.5 percent of the husband's earnings to their individual PRAs. At retirement, they would have a combined PRA of more than $288,000, which could be used to purchase a joint and survivor annuity[8] that would provide $1,553 per month for life. Combined with their reduced traditional Social Security benefits of $995, this would provide them with a monthly retirement benefit of $2,548.

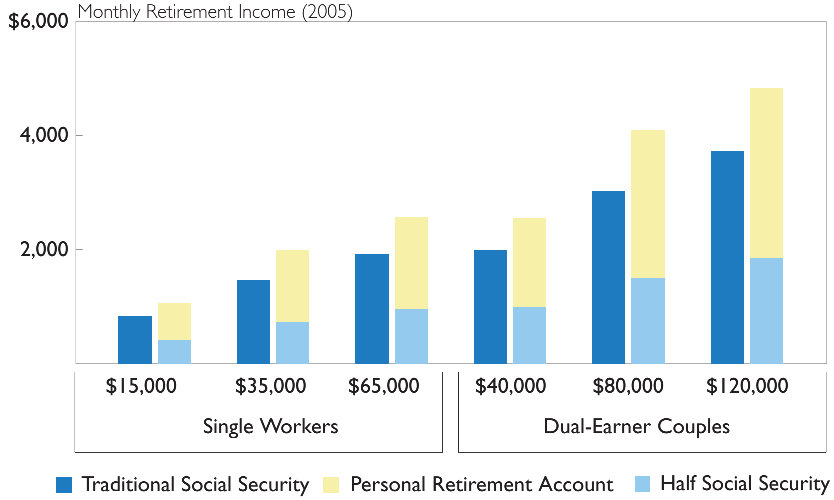
Under current law, the couple would receive Social Security benefits of only $1,990 per month. Put another way, the couple's retirement income would be 28 percent higher if they had been allowed access to PRAs 40 years ago.

Case 2a: Moderate-Income Single Worker. The single worker earning $35,000 per year would have been able to set aside 5 percent of his or her earnings in a PRA. At retirement, the worker would have a PRA of more than $215,000, which could be used to purchase an annuity that would provide $1,244 per month for life. Combined with the reduced traditional Social Security benefit of $734, this would provide the worker with a monthly retirement benefit of $1,978.

4. The Social Security earnings cap for 2005 is $90,000.
5. Kirk A. Johnson, Ph.D., "What If the Baby Boomers Had Personal Retirement Accounts? An Analysis of Retirement Security for Americans Age 40–58," Heritage Foundation *Center for Data Analysis Report* No. 05–02, February 10, 2005, at *www.heritage.org/Research/SocialSecurity/cda05-02.cfm*.
6. The estimates of current-law Social Security benefits are from Social Security Administration, "Social Security Detailed Calculator," updated November 1, 2004, at *www.ssa.gov/OACT/ ANYPIA/anypia.html* (January 25, 2005). The annuity estimates are from Federal Retirement Thrift Investment Board, "Annuity Calculator," at *calc.tsp.gov/annuityCalculators/annuity.cfm* (January 25, 2005). This analysis uses the current 4.25 percent Thrift Savings Program interest rate factor and assumes a purchase of an annuity with an increasing benefit rider to keep up with inflation in all three cases.
7. Figures do not sum exactly because of rounding.
8. A joint and survivor annuity is an "annuity that makes payments for the lifetime of two or more beneficiaries (frequently husband and wife). If one annuitant passes away, payments continue to the survivor as specified in the contract." NetExchange Client, "Investment Glossary," at *www.netxclient.com/universal2/invest_glosry_J.htm* (March 18, 2005). This particular annuity pays 66 percent of the monthly benefit upon the death of one of the spouses.

Chart 1 B 1836

Higher Retirement Income with PRAs



Note: For each earnings level, the bar on the right is the total of the PRA plus the half Social Security benefit.

Sources: Social Security Administration, "Social Security Detailed Calculator," updated November 1, 2004, at *www.ssa.gov/OACT/ANYPIA/anypia.html* (January 25, 2005), and Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation: 2003 Yearbook, Market Results for 1926–2002* (Chicago, Ill.: Ibbotson Associates, 2003), Table 2–6.

Table 1 B 1836

Retirement Income Gains with PRAs

		Increase over Social Security	
	Earnings Level	Monthly Increase	Percentage Increase
Single Earners			
	$15,000	$221	26.5%
	$35,000	$510	34.8%
	$65,000	$663	34.7%
Dual Earners			
	$40,000	$558	28.0%
	$80,000	$1,064	35.2%
	$120,000	$1,109	29.8%

Sources: Social Security Administration, "Social Security Detailed Calculator," updated November 1, 2004, at *www.ssa.gov/OACT/ANYPIA/anypia.html* (January 25, 2005), and Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation: 2003 Yearbook, Market Results for 1926–2002* (Chicago, Ill.: Ibbotson Associates, 2003), Table 2–6.

Under current law, the low-income worker would receive Social Security benefits of only $1,468 per month. Much like the low-income worker, the worker's higher retirement income would be nearly 35 percent higher ($510 per month) if he or she had been allowed access to a PRA.

Case 2b: Moderate-Income Dual-Earner Couple. The couple with combined earnings of $80,000 per year would have been able to set aside 5.5 percent of the wife's earnings and 4.5 percent of the husband's earnings in their individual PRAs. At retirement, they would have a combined PRA of more than $478,000, which could be used to purchase a joint and survivor annuity that would provide $2,575 per month for life. Combined with the reduced traditional Social Security benefit of $1,511, this would provide the couple with a monthly retirement benefit of $4,086.

Under current law, the couple would receive Social Security benefits of only $3,022 per month. Put another way, the couple's retirement income would be 35 percent higher if they had been able to choose personal retirement accounts 40 years ago.

Case 3a: High-Income Single Worker. With average earnings of $65,000 per year, the worker would be near the Social Security wage cap. This case therefore shows the high end of what is possible with this kind of reform. Assuming that 3.5 percent of the worker's earnings was deposited into the worker's PRA beginning in 1965, the worker would have a PRA of more than $280,000 by retirement, which could be used to purchase an annuity that would provide $1,618 per month. Combined with the reduced traditional Social Security benefit of $955, this would provide the worker with a monthly retirement benefit of $2,572.[9]

Under current law, the low-income worker would receive Social Security benefits of only $1,909 per month. Therefore, the worker would receive 35 percent more in benefits with PRAs than would be the case under traditional Social Security.

Case 3b: High-Income Dual-Earner Couple. The couple with combined earnings of $120,000 per year would have a combined PRA of nearly $551,000 at retirement, assuming that 4 percent of the wife's earnings and 3.5 percent of the husband's earnings was set aside in their PRAs. At retirement, their PRAs could be used to purchase a joint and survivor annuity that would provide $2,966 per month for life. Combined with the reduced traditional Social Security benefit of $1,858, this would provide the couple with a monthly retirement benefit of $4,824.

Under current law, the couple would receive Social Security benefits of only $3,715 per month. Put another way, the couple's retirement income would be nearly 30 percent higher if they had been able to take advantage of PRAs.

Summary. Chart 1 summarizes these figures and shows the opportunity loss caused by not making PRAs available to these workers in the mid-1960s. Their monthly retirement incomes would have been between $221 and $1,109 higher if they had been allowed access to PRAs for the past 40 years.

Furthermore, purchasing an annuity with the full amount of the PRA is only one way that these new retirees could use their accounts. Because the retirees would own their PRAs, they could alternatively choose to convert just enough to provide monthly benefits equal to traditional Social Security benefits. They could then use the remaining balances of their PRAs for other purposes, including starting a business, leaving a bequest to heirs, or donating to favorite charities.

Conclusion

Personal retirement accounts show tremendous promise for increasing Americans' retirement security. This simulation shows that if typical workers had been given access to PRAs 40 years ago, their retirement incomes would be much higher than is the case under traditional Social Security alone. This analysis concludes that reforming Social Security to include PRAs would have the following benefits:

- New retirees would have higher retirement incomes with PRAs than they can expect under current-law Social Security. The monthly retirement income for the average worker would be about 30 percent higher with PRAs.

9. Figures do not sum exactly because of rounding.

- This percent change translates into hundreds of dollars in additional monthly retirement income.
- These higher incomes more than offset the reduction in traditional Social Security benefits that would typically come with such reform (to eliminate double-dipping).
- Additionally, if retirees did not choose to convert all of their PRA wealth into an income stream, they could leave the money to their heirs or charity or use it for other purposes.

Sadly, current retirees missed out on such an ownership society and are therefore relegated to the paltry returns of traditional Social Security. Even so, this research underscores the tremendous potential of PRAs for Generation Xers and following generations. Congress should act now—in this legislative session—to implement these important ownership society reforms.

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