

Should Social Security Be Included When Projecting Retirement Income?

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Abstract

There is growing debate among financial service professionals about whether to include Social Security income in the retirement income projections of their clients. This article concludes that planners should not ignore Social Security income and that those who do ignore it will grossly overstate the amount a client will need to save for retirement (especially for clients in the bottom four economic quintiles). An in-depth look is taken at the substantial reasons that ensure some income from Social Security long after the political solutions and transitional changes are completed. This article concludes by asserting that whether the ultimate solution is privatization, reduced benefits or something else, planners and clients alike would be ill-advised to completely overlook Social Security benefits when planning for their retirement.

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Financial services professionals are constantly bombarded with conflicting information concerning Social Security's fiscal viability, its future form (if any) and its relationship to retirement planning in general.¹ One thing is indisputable: the demographic realities of baby boomers approaching the retirement phase of their life cycle makes it clear that Social Security cannot meet all of the financial obligations of its promised future benefits. Unfortunately, misinformation, political agendas from both sides of the aisle and uneducated bias (often in the form of consumer surveys) obscure the pertinent facts essential for proper planning. For example, it is not uncommon to read media reports emphasizing that planners and their clients should not count on any Social Security, or to read reports that privatization will enable planners and their clients to get more from the system than they can currently expect to receive. Obviously, the exclusion, inclusion or partial inclusion of Social Security benefits in the retirement plan can have a significant impact on the amount needed to be saved and on the success of a client to retire with financial security.

The purpose of this article is to make an unbiased and apolitical examination of the situation so that financial services professionals can plan for their clients based on fact, not fiction. To accomplish this, two major issues need to be considered: (1) the continued ability of Social Security to meet its obligations and (2) the role of a modified Social Security system in retirement planning. It is not the intent of this article to support or criticize any solution for fixing Social Security. Rather it is assumed that financial planners must play the hand that is dealt them. At this point, not knowing what that hand will be, it is important to consider all scenarios and plan accordingly for your clients.

Eliminating Social Security Benefits from Projected Retirement Income

To bring the topic into sharper focus, it is illustrative to examine the impact of ignoring Social Security benefits when projecting retirement income. While it is obvious to all financial services professionals that this will increase the required accumulation needed from savings, what is not so readily apparent is the potential magnitude of the increase.

Table 1 looks at four hypothetical income/age client scenarios: Client One, 46 years old with \$100,000 income; Client Two, 46 years old with \$200,000 income; Client Three, 32 years old with \$40,000 income; and Client Four, 32 years old with \$75,000 income. For the typical financial planner, these four hypothetical scenarios should be applicable to their client base. Using the "Ballpark Estimate," a retirement calculator sponsored by the American Savings Education Council, the total accumulation requirements, along with the annual savings needed to achieve the accumulation targets, were calculated assuming 100 and 0 percent Social Security benefits respectively.

As shown in Table 1, for Client One and Client Two, the annual increase in savings required is \$14,737 when Social Security benefits are excluded from projected retirement income. The annual increase in required savings is the same for both hypothetical clients because both of their incomes bump up against the OASDI contribution and benefits base. Assuming that the hypothetical clients continue to pay OASDI taxes, but have no expectation of receiving Social Security benefits, Client One would have a 36 percent annual decrease in potential income spent and Client Two a 22

percent decrease. The present value of this annual decrease, with a six percent discount rate, is \$168,998. One would doubt that either client, both of whom would be considered maximum income earners under OASDI guidelines,² would consider this an insignificant amount. This pattern is also borne out for the younger clients; clients Three and Four must annually decrease their potential income spent by 123 percent and 103 percent respectively.

TABLE 1

**Impact of Eliminating Social Security Benefits
When Calculating Projected Retirement Income**

	Client One ¹		Client Two ¹	
Current Income	\$100,000	\$100,000	\$200,000	\$200,000
Social Security ²	24,960	0	24,960	0
Accumulation Target	738,655	1,148,000	1,886,655	2,296,000
Annual Savings Required ⁴	26,591	41,328	67,919	82,656
	Client Three ³		Client Four ³	
Current Income	\$40,000	\$40,000	\$75,000	\$75,000
Social Security ²	14,227	0	29,012	0
Accumulation Target	225,877	459,199	385,203	860,999
Annual Savings Required ⁴	3,614	7,347	6,163	13,775

1. Both Client One and Client Two are 46 years old and assumed to retire in 20 years at their normal retirement age of 66.
2. Social Security benefit amounts taken from Table B.2.5 of the 2000 Annual Report of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, March 30, 2000.
3. Both Client Three and Client Four are 32 years old and assumed to retire in 35 years at their normal retirement age of 67.
4. To meet the accumulated savings projected in the Ballpark Estimate retirement calculator.

Results using alternative retirement calculators and alternative starting assumptions also confirm this disparity with regard to financial security.³ In other words, the elimination of Social Security from a client's retirement income will have a significant impact on the private savings a client needs to accumulate regardless of the client's income level and current status with regard to retirement assets.

Why All the Negative Press?


According to the *2000 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance Disability Insurance Trust Funds*, under intermediate cost assumptions, the assets of OASDI are expected to increase from the current level of 218 percent of estimated expenditures to 406 percent at the beginning of the year 2010. Tax income is projected to fall short of expenditures in 2015, and total income, including interest earnings on the trust fund, is expected to fall short of expenditures beginning in 2025. The assets are expected to be exhausted in 2037, after which yearly deficits in the program will accumulate through 2075 and beyond. High cost assumptions lead to exhaustion of the assets in 2026 and low cost assumptions lead to a positive balance, and hence financial solvency, extending indefinitely into the future. Relative to the intermediate cost assumptions, the high cost assumptions are more pessimistic with regard to OASDI financing and the low cost assumptions more optimistic.

Understandably, most commentators have concentrated on the intermediate cost assumptions. Using these assumptions, Table 2 presents the inflation-adjusted yearly projected income (excluding interest) and expenditures for the program.

Looking at Table 2, several different values can be calculated for the unfunded liabilities of the future promised benefits under the current program. Starting in 2037, the year the trust fund assets are expected to be depleted, and summing the balance column through 2075 yields an unfunded liability in constant dollars of \$17.6 trillion. Alternatively, if one holds the viewpoint that the trust fund assets should not be considered because they are held on paper in the form of special government security issues, then the summation would start with year 2015 when annual income excluding interest begins to fall short of annual expenditures. This sum totals \$21.6 trillion. Calculating the accumulated balance starting in year 2025, when total income that includes interest first falls short of annual expenditures, shows unfunded liabilities of \$20.7 trillion. Either way you view the trust fund as an asset issue, the calculated unfunded liability of future promised benefits under the current system is quite large. The figure most often reported in commentary and the press is \$21 trillion.

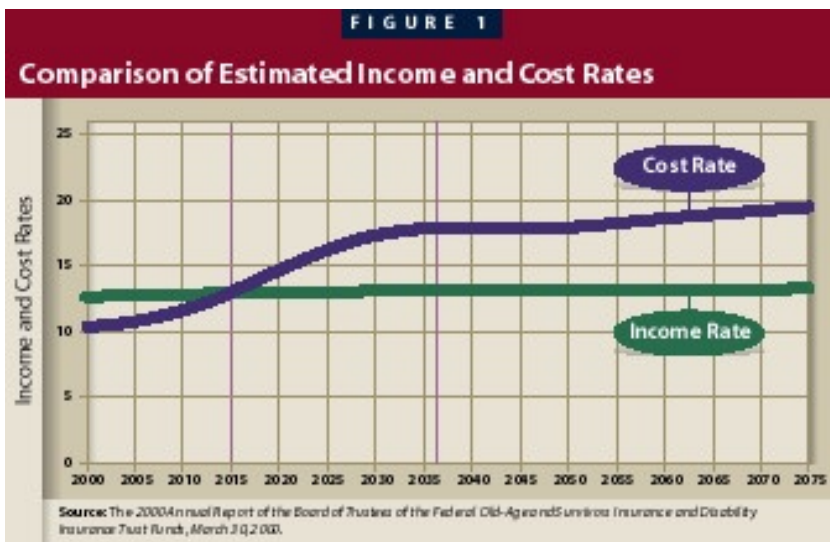
TABLE 2

**Estimated OASDI Income Excluding Interest and Outgo
In Constant Dollars for Calendar Years 2014–2075 (in billions)**

Year	Income excluding interest	Outgo	Balance		Year	Income excluding interest	Outgo	Balance
2014	632.09	623.76	8.33		2045	969.61	1316.40	-346.79
2015	641.72	648.54	-6.83		2046	981.72	1333.30	-351.59
2016	651.85	674.68	-22.83		2047	994.05	1350.65	-356.60
2017	661.86	701.41	-39.55		2048	1006.31	1368.75	-362.43
2018	671.66	729.65	-57.99		2049	1018.81	1387.15	-368.34
2019	681.27	758.12	-76.85		2050	1031.27	1406.37	-375.10
2020	691.15	786.64	-95.49		2051	1043.85	1426.64	-382.79
2021	700.75	815.16	-114.41		2052	1056.62	1447.91	-391.29
2022	710.51	843.51	-133.00		2053	1069.49	1470.14	-400.65
2023	720.34	871.58	-151.25		2054	1082.56	1492.98	-410.42
2024	730.24	898.90	-168.66	2055	1095.72	1516.39	-420.67	
2025	740.11	926.71	-186.60	2056	1109.09	1540.10	-431.01	
2026	749.89	953.54	-203.65	2057	1122.70	1564.38	-441.68	
2027	760.40	979.82	-219.42	2058	1136.46	1588.93	-452.46	
2028	770.70	1005.49	-234.79	2059	1150.43	1613.87	-463.44	
2029	781.53	1029.70	-248.17	2060	1164.64	1639.05	-474.41	
2030	792.40	1053.23	-260.83	2061	1178.86	1664.46	-485.60	
2031	803.65	1076.08	-272.44	2062	1193.28	1690.08	-496.80	
2032	814.78	1098.52	-283.74	2063	1207.94	1715.91	-507.97	
2033	826.13	1119.84	-293.71	2064	1222.70	1741.88	-519.18	
2034	837.91	1139.65	-301.74	2065	1237.62	1768.00	-530.37	
2035	849.38	1158.01	-308.63	2066	1252.59	1794.46	-541.87	
2036	861.47	1174.99	-313.52	2067	1267.87	1821.22	-553.35	
2037	873.16	1191.55	-318.40	2068	1283.22	1848.09	-564.88	
2038	885.27	1207.32	-322.05	2069	1298.78	1875.39	-576.61	
2039	897.42	1222.56	-325.14	2070	1314.31	1902.89	-588.58	
2040	909.27	1237.80	-328.54	2071	1330.05	1930.75	-600.70	
2041	921.29	1252.67	-331.38	2072	1345.97	1958.89	-612.91	
2042	933.18	1268.18	-334.99	2073	1361.98	1987.41	-625.43	
2043	945.39	1283.69	-338.30	2074	1378.78	2016.40	-637.62	
2044	957.30	1300.04	-342.74	2075	1394.45	2045.67	-651.22	

Source: Table II.B1 and Table II.B2 from the 2000 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, March 30, 2000.

Another way to look at the mathematics of the situation is to compare income and expenditures as percentages of taxable payroll. Called income and cost rates respectively, these rates are graphically shown in Figure 1.



The income rate ranges from a current value of 12.65 percent of taxable payroll to a projected 13.34 percent in 2075.⁴ Cost rates start at 10.34 percent of taxable payroll and are expected to increase to 19.53 percent by 2075. The rates are equal, at approximately 12.8 percent of taxable payroll, at some point between years 2014 and 2015. One can easily see that the driving force behind the financial shortfall is the projected increase in the cost rate of roughly 80 percent between now and 2037 when the trust fund is depleted. At that point, the income rate is expected to equal 13.15 percent of taxable payroll, compared with a cost rate of 17.89 percent.

Consequently, beginning in 2037, absent a change to the current system, Social Security will only be able to pay 72 cents for every dollar in promised benefits owed. The reasons for this shortfall are simple. First, the ratio of workers to retirees has been declining steadily since the inception of the program and will continue to decline over time. One startling fact is that today, 44 million Americans receive Social Security checks under the OASDI program, but, as the baby boomers retire from the workforce, that number will increase to 80 million beneficiaries by 2020. Second, people are living longer in retirement and, hence, collecting benefits longer. When the Social Security system was created in 1935, a 65-year-old had an average life expectancy of 12.5 years. Today it is 17.5 years and rising.

For the foregoing reasons, it has become disturbingly common to encounter exposés regarding the elimination of Social Security based on either impending bankruptcy or political instability owing to the potential bankruptcy. Consequently, some argue that Social Security will not be available when baby boomers retire.

However, we contend that no matter what political solution is implemented, the Draconian views of the looming crisis and 2037 bankruptcy have been overstated and they have put unnecessary fears into planners and consumers alike. The resulting overreaction by some planners who call for the elimination of Social Security benefits when calculating a client's retirement needs is not strategically sound. It is important to point out that over the last four years, the estimated actuarial balance has been decreasing, with a corresponding delay in the expected trust fund exhaustion date. According to the *1997 Annual Report of the Board of Trustees*, under the intermediate cost assumptions at that time, the actuarial deficit was 2.23 percentage points, as opposed to the 1.89 estimate today. Correspondingly, in the 1997 report, the trust fund was expected to be depleted in the year 2029. Obviously, the last four years have turned out much better than anticipated in 1997, primarily because of higher GDP growth rates and labor productivity than assumed in the actuarial projections. It is not inconsequential to point out that if these higher rates are sustainable, we then move to the current low cost assumptions and the actuarial deficit disappears.

While it is plausible to assume that the "bankruptcy" date will continue to be postponed, this is not to say that Social Security as we know it today will exist for your clients in the future. On the contrary, the only thing certain is change. Planners who are reluctant to fully count on Social Security as it exists today are wise to take this precaution. However, financial planners and their clients should count on the financial viability of something from Social Security (or its replacement system) beyond 2037.

Why Social Security Can Stand Up and Be Counted

Social Security has consistently provided a base of income against poverty in old age with a replacement ratio to the average wage earner of 40 percent. Today the replacement ratio for wage earners who retire at the normal retirement age is 52.8 percent for those in the low earnings category, 39.2 percent for average earnings, 31.7 percent for high earnings and 23.7 percent for maximum earnings.⁵ These replacement ratios are projected to increase through 2075 to 56.2 percent, 41.9 percent, 34.4 percent and 27.5 percent respectively.⁶ For two-thirds of the American elderly, Social Security benefits provide the major source of income; for one-third it is virtually their only source of income. Absent Social Security retirement benefits, many of these Americans would almost certainly fall below the poverty level during their retirement years. Indeed, the program has helped cut the elderly poverty rate in America by two-thirds since 1960.⁷ Put another way, one reason to count on Social Security (or its replacement) in retirement planning is America's dependence on it.

Today, 27 million retired Americans, 4 million disabled workers, and 13 million of their dependents and survivors are receiving monthly benefits under the OASDI program. By all accounts, it is an efficient system in that its administrative costs are surprisingly low at less than one cent for every dollar collected. It is safe to say that the OASDI program has made a positive difference in the lives of many Americans by enabling them to enjoy a more comfortable retirement. It is therefore somewhat inconceivable that the system would be eliminated because of the projected financial shortfall. However, even if one believes the system is inefficient and non-essential, there are still some startling hurdles to surmount before its elimination.

Perhaps the most compelling reason to argue for the inclusion of promised future benefits in retirement income projections is that the complete abandonment of the system is simply politically untenable, if only because it is protected by AARP, one of America's strongest political interest groups. Moreover, historically, Congress has had difficulty in making minor adjustments to the program; if it is politically difficult to suggest modest changes, how is it possible to reasonably expect elimination? Finally, our new president and Congress have not advocated eliminating the system; quite to the contrary, they both made "saving Social Security" a major theme of their campaigns.

An equally compelling reason to believe Social Security will provide income for your clients is that no one has suggested elimination! There are few Americans who won't offer suggestions on how to change the system but virtually no serious person or organization has proposed to eliminate the system. For example:

- The Concord Coalition (a noted fiscal watchdog) has published a booklet titled *Securing Social Security: A Framework for Reform*,⁸ in which it says, "Social Security has provided a vital floor of protection. It would be hard to imagine America without it."⁹
- The Urban Institute, a nonprofit policy research organization, has published a fact sheet outlining Social Security reform, asking whether it is too late to repair the Social Security system. "No, with adequate forethought and preparation, reform can still guarantee that almost all future retirees will receive lifetime benefits at least as great as those of Americans who retired before them. In general, benefits can be maintained but growth at its current promised rate cannot."¹⁰
- The Employee Benefits Research Institute (EBRI), a nonpartisan organization with 20 years' experience in analysis of pension issues, writes, "The viability of America's long-term retirement policies rests on a three-legged stool: Social Security, private and public pension plans and personal savings."¹¹

Yet another reason to assume Social Security will exist in some form or another can be seen when examining retirement across the globe. In essence, almost every industrialized nation in the world has some form of Social Security.¹² In many instances, other industrialized nations provide a greater replacement ratio from Social Security than the United States.¹³ It is highly unlikely that Americans would abandon a system that is part of the retirement philosophy of the world.

A final reason to believe that clients will get income from Social Security is that the proposed legislative solutions needed to fix Social Security are not drastic. Put another way, it may not be fair to suggest that when the dust settles, changes will not be significant, but it is less fair to argue that changes will be so drastic that we can't count on any income from the current system or its replacement. Table 3 illustrates many of the proposed solutions and their effect on Social Security. The solutions, no matter what the ultimate outcome, leave a system intact that will resemble our current system.¹⁴

TABLE 3

Proposed Solutions and Their Effect on Social Security	
Potential Solution	Comment
Raise the payroll tax rate 1.1% each on employer and employees	The system would be solvent for 75 years. In the 76th year, a new charge would be needed because income would be sufficient to finance only about three-quarters of promised benefits.
Eliminate the wage-base cap or increase the wage base to 90% of covered earnings (about \$100,000)	Much additional revenue would be produced but unless other changes were made, benefits for wealthiest would also increase; raising the cap to 90 percent of covered earnings solves about one-fifth of the long-term problem.
Raising taxes on revenues	A modified means test. If the thresholds were eliminated and up to 85 percent of all benefits were includable in federally taxable income, amounts equal to 0.21 percent of payroll would be generated.
Increase normal retirement age	Depending on specifics, it could eliminate the problem.
Change the benefit formula	Depending on specifics, it could eliminate the problem.
Means testing	A Concord Coalition proposal that reduces full benefits to 90 percent for incomes of \$50,000–\$60,000, and allows only a 15 percent benefit for people with incomes of \$130,000 or more could solve between 50 percent to 75 percent of the long-range financing problem (currently 4.4 million people with incomes greater than \$50,000 receive Social Security).
Reduce COLAs	A \$500 benefit in 1975 grew to \$1,053 by May 1984. It would have only grown to \$1,006 if COLAs had been slowed by one-half of a percentage point.
Privatize	Depending on specifics, it could eliminate the problem.
Combine options	Depending on specifics, it could eliminate the problem.

Where Does This Leave the Retirement Planning Process?

Despite the political virtues of the OASDI program extolled earlier, it is still true that under current law, the system cannot financially meet all of its future promised benefits. So, while it is not reasonable to eliminate Social Security benefits when projecting retirement income, it is also not fair to leave the impression that there will not be significant changes made in the program. Of course, since no one has a crystal ball, knowing that some kind of adjustments will most likely be made introduces an additional degree of uncertainty into the retirement planning process.

A variety of proposed changes all maintain the current basic defined-benefit structure, including making no changes at all. At the other end of the spectrum, there is the possibility of a major restructuring into a defined-contribution program. Increased pre-funding, under either a defined benefit or defined-contribution structure, is also part of the discussion. To gain insights on how to adjust the retirement planning process in the face of this uncertainty, it is helpful to examine the context of the most frequently mentioned potential solutions.

Changes with Limited Implications to the Planning Process

Potential changes that appear alone, and in combination, in a variety of different reform proposals include frozen or reduced cost-of-living adjustments (COLAs), increased taxation of Social Security benefits, and calculating average indexed monthly earnings using 40 instead of 35 years. Each and all of these changes are easily incorporated into the retirement calculator framework. For instance, frozen or reduced COLAs could be accounted for by examining historical COLA levels and discounting or eliminating their use in the future. Second, taxation of Social Security benefits could be accounted for by assuming benefits would be fully taxed, and subtracting the amount lost to taxes from the projected Social Security benefits. Third, average indexed monthly earnings could be adjusted to give a recalculated primary insurance amount.

Still other changes would seemingly have no impact on how you calculate your client's benefit. For example, another proposed change is to include more people in the system. The Social Security Administration estimates that extending mandatory Social Security coverage to all newly hired state and local government employees would reduce the program's long-term actuarial deficit by ten percent and would increase the trust fund's solvency by about two years. This change would have no impact on your private sector client's Social Security benefits and should not result in an adjustment in the current calculations.

What Happens If a Legislative Solution Is Not Forthcoming

Notwithstanding everything that has been said, some might still argue that Social Security will go bankrupt in 2037 because the system will not be fixed by legislative solutions. As implausible as this sounds, financial planners should note two things. First, this means many years of retirement for baby boomers (who begin to turn 65 in 2011) will be protected by a system that can fund full benefits. Second, even in 2037, the system will still be able to fund 72 cents for every dollar in promised benefits. According to the Concord Coalition,¹⁵ this means that the typical worker born in 1960 would lose 8 percent of lifetime benefits, the worker born in 1980 would lose 29 percent and the worker born in 2000 would lose 33 percent. Looking at it another way, a person born today would receive over two-thirds of the lifetime benefits they could expect today, even if the system continued without a legislative adjustment.¹⁶ Thus, planners who feel the worst-case scenario of no solution can only justify reducing benefits by these amounts.

Question of Means Testing

Perhaps the most worrisome potential change to contend with is means testing. Planners who argue that means testing would eliminate benefits for their wealthiest clients may end up being correct. Therefore, planners who believe means testing will be one of the solutions to fix Social Security may be justified in severely limiting Social Security benefits for some clients. However, it is not realistic to assume that benefits will be eliminated for clients with more moderate incomes, and most proposals for means testing allow even the wealthiest to receive 15 percent of their promised benefits. In addition, means testing currently is the least likely option to be chosen. Consider the fact that the National Committee to Preserve Social Security and Medicare opposes the means testing of Social Security and Medicare benefits.¹⁷ Moreover, the recent elimination of the earnings cap for workers aged 65–69, and the proposed legislation to roll back or eliminate the taxation of benefits, are contradictory to the intention of means testing.

Social Security Advisory Council Proposal

One of the most ambitious proposals for modifying the OASDI program comes from the Social Security Advisory Council (1997). The Council offered three alternatives, the third of which would go a long way in moving the system from a non-privatized defined-benefit system toward a defined-contribution system. This third proposal recommends the following:

- The creation of defined-contribution individual accounts, referred to as personal saving accounts (PSAs). For workers under age 55 (in 1998), 5 percent of the current 12.4 percent payroll tax would be put into a PSA that would be privately invested by individuals or their designated broker. (After-tax contributions would be tax free at retirement.)
 - The other portion of Social Security payroll taxes (7.4 percent) would fund a modified defined-benefit structure equal to about one-half of the defined benefit under the current system, or two-thirds of the poverty level—\$410.
- The age for full benefits would be accelerated beginning in 2000 until age 67 for those reaching age 62 by 2011 (projected to be about one month every two years). At the time it reaches 67, it would be indexed to reflect changes in life expectancy.
- The age to receive early retirement benefits would be gradually increased from 62 to 65 (although 62 would be the age at which benefits would be able to be withdrawn from PSAs).
- Additional federal debt would be incurred to finance the transition to the new system.

Given this mix of proposed modifications, the probability of some type of increase in the legislated normal retirement

age is most likely high. It has already been done once in the 1983 legislation. Accelerating the 1983 change in the normal retirement age from 65 to 67, and then indexing the age to reflect changes in life expectancy, would go a long way to solving the detrimental impact that longer life expectancies are having on the current projected financial shortfall. Assuming a change like this takes place before your client's benefits begin would require that you discount the amount of expected Social Security benefits when projecting retirement income. Since the precise change in the normal retirement age today is unknown, the discount could be based on the delayed receipt of benefits until a chosen age (67–70). In this instance, the retirement calculator need only be adjusted for the length of time annual benefits will be received.

The most notable aspect of the Social Security Advisory Council's proposal is the recommendation to convert part of the OSADI program into a defined-contribution plan. It is hard to say whether the net results to any individual client would be an increase or decrease in the Social Security benefit used in the retirement income projection.

To study the distributional impacts of a defined-contribution system, Feldstein and Liebman¹⁸ develop a model simulation of a pre-funded system in which a portion of the payroll tax contributions is paid into personal retirement accounts. They assume that these accounts are annuitized into variable annuities upon a person's retirement. Using a 5.5 percent real rate of return on a portfolio consisting of 60 percent stocks and 40 percent bonds, they conclude that 92 percent of all beneficiaries would receive greater benefits than those promised under the current system. When breaking down the results by income quintiles, they find that 99 percent of married couples in the highest quintile would receive higher benefits compared with 60 percent in the lowest quintile.

These results have in turn been criticized on the grounds that the economic growth projections needed to generate a long-term average real return of 5.5 percent are more consistent with the low cost assumptions of the *2000 Annual Report*. Of course, under the low cost assumptions, the long-term actuarial deficit disappears. Some have argued that the intermediate assumptions are more consistent with a lower average real return in the neighborhood of 3.8 percent. Taking this into account, Feldstein and Liebman run the simulations using a 3.5 percent average real return. Under this scenario, they conclude that 43 percent of all beneficiaries would receive greater benefits than promised by the current system. For married couples, 56 percent in the highest quintile would receive greater benefits compared with 1 percent in the lowest quintile. They point out, however, that the losses for those who would not receive greater benefits are relatively small. Hence, the total gain to the "winners" exceeds the total loss to the "losers."

Implications of Conversion to A Defined-Contribution Program

From a planning perspective, the transformation of the system, or a portion of the system, from a defined-benefit to a defined-contribution program would create the largest potential impact. Under a defined-benefit structure (assuming future promised benefits will be met), a certain portion of projected retirement income is not subject to the uncertainty of the period-average real rate of return that applies to annual savings that fund the retirement accumulation. Moving Social Security benefits toward defined-contribution payments subjects a larger amount of projected retirement income to this market risk. After assessing the risk tolerance of their clients, financial planners will have to alter recommended investment strategies accordingly.

Planners also need to consider the timing risk inherent in retirement projections. Retirement calculators base their calculations on average returns, with the understanding that the averages will include both bull and bear markets. However, for retirees, the timing of market breaks can have a substantial impact on the allowable withdrawal rate applied against accumulations providing the target standard of living.

Mike McNamee¹⁹ offers the example of a couple who might have retired in 1968 with \$1 million accumulated in a portfolio composed of 60 percent stocks, 30 percent bonds and 10 percent cash. The historical record shows that this portfolio paid an average annual return of 11.7 percent. This should have sustained an 8.5 percent withdrawal rate (\$85,000 annually) over the 30-year period. However, this period includes both the bull market existing since 1982 and the bear market of 1973–74. This couple unfortunately will hit the bear market first. Quoting an estimate by mutual-fund firm T. Rowe Price, McNamee notes that combining the couple's \$85,000 annual spending with the 40 percent drop in stock prices, and the high inflation of the 1970s, would have caused this couple to go broke by 1981. Consequently, when the bull market started the following year, there would be nothing left in the portfolio to earn the higher returns.

The moral of the story is that, even if your portfolio earns the anticipated average rate of return during the accumulation years, the timing of the market cycles during the retirement years can substantially affect the sustainable withdrawal rate. The income base provided by Social Security under a defined-benefit structure can offset this risk to some extent. Moving toward a defined-contribution system leads to a larger portion of the projected retirement income being subjected to this timing risk, thereby accentuating the need for planners to appropriately incorporate this risk when calculating the target accumulation amount.

Obviously, converting the OASDI program to a defined-contribution system would have a significant impact on the risk analysis involved in retirement planning. What is the likelihood that this conversion will happen? Many of the proposals put forward by politicians include some type of individual retirement savings account as part of the reform package. Therefore, one would have to conclude that there is at least a chance that some aspect of a defined-contribution system will be initiated. The unknown at this time is the magnitude of the conversion and whether it will be mandatory or voluntary. Given the drastic restructuring that would be required, and the large transition costs, it seems most likely that any conversion will be limited in nature. Likewise, the political ramifications of the distributional analysis of Feldstein and Liebman point to a change with voluntary participation (the proposals of both major presidential candidates included the provision on a voluntary basis).

Concluding Remarks

The starting point for determining the amount of future promised benefits to include in the projection of retirement income should still be your client's Personal Earnings and Benefit Statement (PEBES) mailed annually by the Social Security Administration.²⁰ These statements contain an estimate of the benefits your client will receive. Some factors to consider include the following:

- The benefits are estimated assuming the client will continue to make about the same as their latest earnings.
- The benefits are given in current dollars.
- The Social Security Administration's Web site allows you to tailor the estimate and calculate it yourself. This is especially useful if your client's earnings are likely to increase or decrease from present levels (see the Web site at www.ssa.gov).

To arrive at an adjustment factor when including promised future benefits in the retirement income projection, planners may find the following information helpful:

- For younger workers, the retirement benefit projections in the Social Security Statement may underestimate their actual benefit. This is because the calculations take a worker's current salary and project it forward, not accounting for salary increases as the worker ages. On the other hand, the Third Millennium (a national, nonprofit, nonpartisan group of Americans born after 1960) has testified before Congress that "since Social Security is [in trouble] this low number could actually, and almost accidentally, turn out to be accurate."²¹
- It is more likely that any changes will still provide benefits approximately equal to current levels for clients who are less affluent than for clients who are more affluent (this might include income levels up to the maximum earnings level as defined by the Social Security Administration). This is consistent with the social adequacy emphasis embedded in the legislation that enacted the various Social Security programs, and virtually all legislative changes made since.
- Changes in the system are more likely to affect younger baby boomers than older boomers. This is largely due to the political realities that will push to grandfather changes, to the extent possible, for those who have little opportunity to adjust their retirement planning.

Even if tomorrow's retirees find themselves with a defined-contribution program, under no circumstances would they not be given enough time and warning to fend for themselves. If the system as we know it does end for younger workers, planners would still need to account for Social Security benefits, or the Social Security alternative provided, in the retirement income projections of their clients.

Planners should be acutely aware that it is not acceptable to say it is okay to ignore Social Security because all that

can happen is that the client's income will be overstated. This is not planning, but a rationalization of a lack of understanding of the retirement calculator as a retirement tool. Financial services professionals should make a conscious estimate of the amount of Social Security their clients will receive. It may be fair to discount the amount received, especially for those in the upper income brackets, and it is always wise to revisit the plan annually to account for changes to the system. But planners should not cut off the third leg of the three-legged stool of retirement security in an arbitrary manner.

Endnotes

1. This article focuses on the old-age portion of Social Security and does not comment on the survivors, disability or health insurance (Medicare) portions of the system.
2. Under OASDI guidelines, those earning 45 percent of the average are in the low income category, those earning 160 percent of the average are in the high income level, and those earning the OASDI contribution and benefit base are considered "maximum income earners."
3. Using different assumptions and calculators (where the only variable change was including Social Security in the calculation or excluding it from the calculation) would be consistent with these results.
4. The income rate is higher than the 12.4 payroll rate because it includes income from taxation of benefits.
5. These statistics account for disability and survivors' benefits as well as old-age benefits.
6. Source: "Social Security Reform," GAO, David Walker Controller General of the United States, November 1999.
7. See Table III.B.5 of the *2000 OASDI Trustee Report*.
8. "Saving Social Security: A Framework for Reform," the Concord Coalition, June 1998.
9. Ibid.
10. Urban Institute Fact Sheet, "Social Security Reform: Ten Basic Questions Answered," L. Eugene Steulle.
11. *EBRI Notes*, Vol. 20, No. 9, September 1999.
12. Social Security started in Germany in the 1870s and has been adopted in one form or another by the majority of western countries.
13. For example, in Sweden the replacement ratio is 85 percent.
14. Even if it doesn't resemble the system, it still would provide retirement income of some form or another, or the client would have sufficient advanced notification that they needed to save more on their own.
15. "What Happens to Benefits When Social Security Goes Bankrupt? The Truth About Entitlements and the Budget," a tax alert from the Concord Coalition, Vol. VI, No. 5, April 19, 2000.
16. Ibid.
17. The National Committee to Preserve Social Security and Medicare Legislative Agenda for the 105th Congress, *Viewpoint*, March 1997.
18. Martin Feldstein and Jeffrey Liebman, "The Distributional Effects of An Investment-Based Social Security System," National Bureau of Economic Research, Working paper 7492, January 2000.
19. Mike McNamee, "The Next Egg May Have Hidden Cracks," *Business Week*, July 31, 2000.
20. Clients under age 25, currently in pay status, clients not covered by Social Security or Medicare and clients who do not have a current mailing address will not automatically receive these statements. These clients can still request a PEBES by submitting Form SSA-7004, calling (800) 772-1213 or applying online at www.ssa.gov.
21. Testimony given April 11, 2000, before the Social Security Subcommittee on the Ways and Means Committee. See www.thirdmil.org.