



Working for a Good Retirement

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May 2006

The Retirement Project

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A crosscutting team of Urban Institute experts in Social Security, Medicare, Medicaid, tax and budget policy, and micro-simulation modeling ponder the aging of American society.

The aging of America raises many questions about what's in store for future and current retirees and whether society can sustain current systems that support the retired population. Who will prosper? Who won't? Many good things are happening too, like longer life and better health. Although much of the baby boom generation will be better off than those retiring today, many face uncertain prospects. Especially vulnerable are divorced women, single mothers, never-married men, high school dropouts, and Hispanics. Even Social Security—which tends to equalize the distribution of retirement income by paying low-income people more than they put in and wealthier contributors less—may not make them financially secure.

Uncertainty about whether workers today are saving enough for retirement further complicates the outlook. New trends in employment, employer-sponsored pensions, and health insurance influence retirement decisions and financial security at older ages. And, the sheer number of reform proposals, such as personal retirement accounts to augment traditional Social Security or changes in the Medicare eligibility age, makes solid analyses imperative.

Urban Institute researchers assess how current retirement policies, demographic trends, and private sector practices influence older Americans' security and decisionmaking. Numerous studies and reports provide objective, nonpartisan guidance for policymakers.

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Abstract

The choice of retirement age is the most important portfolio choice most workers will make. Drawing on the Urban Institute's Dynamic Simulation of Income model (DYNASIM3), this report examines how delaying retirement for nondisabled workers would affect individual retiree benefits, the solvency of the Social Security trust fund, and general revenues. The results suggest that delaying retirement by itself does not generate enough additional revenue to make Social Security solvent by 2045. Benefit cuts or supplementary funding sources will be necessary to achieve solvency. However, the size of the benefit cuts or tax increases could be minimized if individuals worked longer. This additional work also substantially increases worker's retirement well-being. Lower-income workers, to the extent they can work longer, have the most to gain from their additional labor. Policy changes that encourage work at older ages will substantially improve both economic and personal well-being in the future.

Executive Summary

When people work longer, they produce additional goods and services for the economy. They also earn more income, usually save some of that income, allow their assets to grow, and increase their annual Social Security benefit by withdrawing money over a shorter period of time. At the same time, they lower Social Security deficits by delaying receipt of government benefits and, quite importantly, pay more taxes—which bolster other government programs.

The broader positive ramifications of additional work have yet to be fully examined. For instance, the Social Security Administration does not report effects of proposed policy reforms on general revenues. To examine these complex interactions, we estimate the effect of increased work using the Urban Institute’s Dynamic Simulation of Income Model (DYNASIM3). Among other items, DYNASIM calculates retirement wealth from earnings, pensions, and Social Security. It also calculates payroll tax and federal and state income tax at the individual and family level from 1992 to 2050. These projections account for the dramatic heterogeneity of individual demographic and economic circumstances and how they evolve over time.

At the individual level, we calculate the change in net wealth and annual future consumption made possible by additional work. At the macro level, we calculate the change in total earnings and in the Social Security deficit due to additional work. We also look at the changes in general revenue that could be used to support other government spending (including spending on the elderly).

Key findings include the following:

- Workers could increase their annual income by an average of 5 percent from age 50 onward for one additional year of work and 25 percent for five additional years of work. The additional net wealth from one more year of work, if annuitized at retirement, could increase consumption by 9 percent per year. Five additional years of work could increase annual consumption at retirement by 56 percent per year.
- Lower-income workers have the most to gain from their additional labor. Workers in the bottom lifetime earnings quintile could increase annual consumption at retirement by 16 percent with one additional year of work and by 98 percent with five additional years of work. Workers in middle-income quintiles also gain relatively greater percentage increases in annual income from additional work than do the richest workers.

- At the macro level, the Social Security earnings generated from just one additional year of work are almost equal to the entire 2045 Social Security shortfall (of benefits from taxes) projected under the baseline scenario. A share of those earnings is paid to the government in the form of taxes, including Social Security taxes. The additional Social Security taxes generated by five years of work alone offset more than half of the Social Security shortfall in 2045. Furthermore, if one takes into account the additional income tax revenues, the government's gain to its unified budget is far greater than the size of the Social Security deficit.
- Looking more narrowly at just the additional Social Security payroll tax, even five more years of work is not enough to close the Social Security funding gap by itself. Some additional reform, such as an increase in the normal retirement age, will likely be required. However, the added payroll tax from the additional work can reduce the size of any benefit cuts or tax increases needed to achieve solvency.
- There is a striking contrast between reforms that simply reduce benefits and reforms that increase work effort while partially reducing benefits. Work-inducing reforms clearly require less benefit cuts to achieve solvency because of the additional revenues. Perhaps more striking, workers on average achieve significantly higher net incomes when additional work is involved—the earnings increases can easily more than offset any benefit cut—and significantly lower net incomes when only benefit cuts are involved.

A number of changes have recently occurred that should encourage more work at older ages. These include the increase in the Social Security normal retirement age, the shift from defined benefit to defined contribution pensions, and the scaling back of retiree health insurance. If workers would merely increase their work efforts by their increases in life spans—Social Security projects that by 2050, people would need to retire about 3 ½ years later to achieve the same 18+ years of retirement support as they get in 2005 at age 65—budgetary pressures could be significantly reduced. Reforms are still likely to be required to deal with long-term imbalances, but some—such as decreasing early Social Security benefits and increasing delayed Social Security benefits, or eliminating the requirement that Medicare be secondary payer—are much more likely to increase work effort than are others.

Introduction

One way of relieving the economic pressures created by an aging population is to encourage workers to delay retirement. When people leave the workforce, they forgo earnings. To replace these earnings, many retirees begin collecting pensions and/or drawing down their assets. Most retirees also begin collecting Social Security benefits. At the same time, retirees pay fewer taxes—not just payroll taxes that support Social Security, but also federal, state, and local income taxes that support other government programs. Thus, the retirement of the boomer generation, some 76 million people, is expected to have a large impact on individuals, the retirement system, and the economy.

The oldest boomers will turn age 62—the age of first eligibility for Social Security benefits and the age at which the majority of retired workers elect to receive benefits—beginning in 2008. Because people are living much longer than before, even substantial increases in work duration would leave future generations with more years of retirement on average than almost all generations living in the past. When Social Security benefits first became payable in 1940, the average worker retired at 68. To retire for an equivalent number of years in 2005 would mean retiring at 74; by 2050, that equivalent age would increase to 78. However, in 2005, workers on average retired about age 63 (Steuerle 2005).

When people work longer, they earn more income, usually save some of that income, allow existing assets to grow, increase their lifetime Social Security benefits, and increase their annual Social Security benefit even more when their lifetime benefits are withdrawn over a shorter period of time. Butrica et al. (2004) estimate that people could increase their annual consumption at older ages by more than 25 percent by simply retiring at age 67 instead of age 62.

An aging population and the approaching retirement of the largest birth cohort in U.S. history could mean an insufficient income stream to pay promised Social Security benefits in 2017. Delaying retirement could ease this logjam. In 2004, the Social Security Old-Age and Survivors Insurance and Disability Insurance (OASDI) Trust Funds paid about \$493 billion in Social Security benefits and received about \$658 billion in revenue. About 84 percent of this revenue came from payroll taxes paid by employees, employers, and the self-employed. Another 2 percent came from income taxes paid on Social Security benefits, and 14 percent came from interest income on OASDI Trust Funds (Board of Trustees 2005).

The Office of the Chief Actuary (OCACT) projects that OASDI revenues (payroll taxes, interest on the OASDI trust funds, and income taxes on Social Security benefits) will be more than enough to pay promised benefits through 2016. After that, boomers retiring in hoards would require trustees to begin redeeming the bonds held by the OASDI Trust Funds. According to current projections, all assets in the Trust Funds will be depleted by 2041. Without reform, benefits received after 2041 will have to be paid solely out of payroll tax and the proceeds from income tax on benefits, which will fall short of benefits promised under current law (Board of Trustees 2005). So working longer would inject the Trust Funds with much-needed cash, especially from the additional payroll taxes.

What's more, workers who delay retirement produce additional goods and services for the economy and pay additional income taxes that increase general revenues used to support other government programs (or, for that matter, used to cover some of Social Security reform). At the same time, these additional revenues from a larger national income reduce tax pressures on younger workers or, alternatively, allow government to spend more on programs other than for the elderly.

This report is the first comprehensive look at how changes in retirement behavior and reforms that encourage workers to delay retirement could impact individual retiree benefits, the solvency of the Social Security Trust Funds, and general revenues. The specific ripple effect of delayed retirement is gauged using projections of retirement age, Social Security take-up age, pensions, Social Security benefits, taxes, and other important sources of income in retirement from the Urban Institute's Dynamic Simulation of Income Model (DYNASIM3).¹ We increase the retirement and Social Security take-up age of nondisabled workers and estimate their Social Security benefits, payroll taxes, and federal and state income taxes. While the report shows the extraordinary possibilities additional work generates, it is not a behavioral study of exactly how people respond to existing incentives. Instead, it measures the economic consequences of delaying retirement under a range of specified behavioral responses. Additional work requires individuals to give up leisure time, but for many individuals, work also comes with improved physical and mental well-being (Calvo 2006).

Findings show that the Social Security earnings generated from just one additional year of work are almost equal to the entire 2045 Social Security shortfall (of benefits from taxes) projected under the baseline scenario. A share of those earnings is paid to the government in the

1. DYNASIM uses OCACT 2005 economic and demographic assumptions including labor force participation rates, average earnings, and mortality.

form of taxes, including Social Security taxes. The additional Social Security taxes generated by five years of work alone offset more than half of the Social Security shortfall in 2045. Further, if one takes into account the additional income tax revenues, the government's gain to its unified account is far greater than the size of the Social Security deficit. While it is harder to depend upon additional work only to close the gap between projected Social Security income and outlays, various combinations of benefit cuts and additional work can still leave the average retiree with significantly higher average retirement income than he or she otherwise might have. The increase in personal wealth from added work more than offsets any decrease in personal wealth due to simulated Social Security benefit cuts. Under all of the simulated reform options, added work leads to a more solvent and more financially secure retirement.

Literature Review

Although numerous studies have examined how our tax and benefit systems affect work incentives, previous research has not measured the combined impact of Social Security, taxes, and employee benefits on the returns to work at older ages. Gokhale, Kotlikoff, and Sluchynsky (2002), for example, compare lifetime earnings for a representative two-earner couple to lifetime taxes and the lifetime value of transfer payments they lose because of work, and conclude that workers give up nearly 50 cents in tax payments and foregone transfers for every dollar they earn. The authors do not, however, examine returns to work at older ages or how returns vary with age. A number of studies have investigated the impact of financial incentives on retirement behavior, especially the role of Social Security and employer-sponsored pension and health plans (Coile and Gruber 2004; Johnson, Davidoff, and Perese 2003; Lumsdaine, Stock, and Wise 1992, 1994; Samwick 1998; Stock and Wise 1990), but they have not focused on how total returns to work change as adults age. Finally, Diamond and Gruber (1999) compute implicit tax rates and replacement rates for prototypical workers, but they ignore the role of federal income taxes and employer-sponsored pension and health insurance plans, which have important effects on work incentives.

Research by Butrica et al. (2004) attempts to fill the gap in this literature by describing the combined impact of Social Security, typical employee benefits, and the tax system on the tax rates, replacement rates, and retirement wealth of representative workers. The authors find that the implicit tax rate on work increases rapidly at older ages, and by age 65, people can typically receive nearly as much in retirement as they can by working (see figure 1). However, the authors

also find that older individuals could substantially increase their financial resources in retirement by working longer.² For example, the representative worker could nearly double his real annual income at age 75, net of health insurance premiums and federal taxes, by stopping work at age 65 instead of age 55. By waiting until age 68 to retire, he would accumulate enough wealth (from pensions, Social Security, and saved earnings) to finance an annual consumption stream at older ages of \$60,000 per year, nearly three times as much as he could finance if he retired at age 55.

This report builds on the research of Butrica et al. (2004) in two primary ways. First, the results in this report are based on a nationally representative sample of the U.S. population, rather than on prototypical individuals. Second, this report examines the consequences of delaying retirement both at the macro and individual level, rather than just the individual level. Specifically, this report considers how additional work influences the Social Security deficit and the taxes that would go to support all government programs within a unified budget, in addition to the lifetime and annual benefit payments in Social Security.

Interaction of Social Security, Pensions, Earnings, and Taxes

This report accounts for the complex interaction between Social Security benefits, pensions, earnings, and taxes to assess how working longer influences individual retiree benefits, the solvency of the Social Security Trust Funds, and general revenues. This section briefly describes how working longer might influence each income source, as well as taxes. Butrica et al. (2004) provides more detail about the provisions of Social Security, tax law, and employer benefit policies as they pertain to the decision to work at older ages.

Working an additional year will generally increase future Social Security benefits, for example, but the relationship between work history and Social Security is complex. Social Security reduces payments for those who collect benefits before the normal retirement age (NRA) and increases benefits for those who delay collecting until after the NRA.³ But delaying take-up also reduces the number of payments they receive. The optimal age of take-up depends in part on mortality expectations: those who survive until very advanced ages will gain more

2. Some of the implicit taxes are returned to workers in the form of higher Social Security benefits and pension income in retirement. Saved earnings from additional employment will increase consumption without increasing taxable income.

3. Social Security reduces benefits by 5/9 of 1 percent for each month that benefits are received before the NRA, up to 36 months. The benefit is further reduced by 5/12 of 1 percent for every month before the NRA in excess of 36. Benefits are increased by 3/4 of 1 percent for each month that initial take-up exceeds the NRA, up to age 70. No credit is given for delaying initial take-up beyond age 70.

from claiming later than those who do not live as long. In addition, beneficiaries who continue to work are subject to the retirement earnings test. For those below the NRA, Social Security withholds \$1 in benefits for every \$2 of earnings in excess of the exempt amount—\$12,480 in 2006. The reduction in benefits is partly offset by higher future benefits.

Traditional defined benefit plans often introduce strong disincentives to work at older ages. Workers with defined contribution pension plans can build up the assets in these accounts through their own, and possibly their employers', contributions. With defined benefit pension plans, however, additional work does not necessarily translate into higher benefits. For instance, many traditional defined benefit plans penalize those who continue on the job after they qualify for full retirement benefits, reducing the lifetime benefits they receive from the plan. Some plans also cap the number of service years that workers can credit toward their pensions, and others cap the share of pre-retirement earnings that the plan will replace in retirement. In addition, for every year that workers remain on the job past the plan's retirement age, they forgo a year of retirement benefits. Pension wealth declines when the increase in annual benefits from an additional year of work is insufficient to offset the loss due to a reduction in the number of pension installments.

Delaying retirement increases lifetime earnings and the ability to support, and possibly increase, current and future consumption. Yet, the individual returns to work are somewhat reduced because workers must pay both payroll and income taxes on most of their earnings. For society as a whole, however, those additional taxes now become available for other purposes, such as covering the cost of Social Security and Medicare.

Methodology

The Urban Institute's Dynamic Simulation of Income Model (DYNASIM3) is used to determine the individual and budgetary consequences of working longer. In DYNASIM, retirement is defined as substantial, but not necessarily complete, withdrawal from the labor force. Specifically, DYNASIM's retirement age represents the age at which a worker experiences at least a 50 percent drop in earnings compared with average earnings earned between age 45 and 50. (The drop in earnings must last for at least two years.) Defining the retirement age this way allows DYNASIM to simulate more gradual transitions to full retirement. A separate DYNASIM module projects Social Security take-up age using discrete-time hazard models based on age,

expected benefit amount, spousal characteristics, and Social Security policy parameters. (See Favreault and Smith [2004] for more detailed information.)

The DYNASIM retirement and Social Security take-up age is increased by one or five years to simulate delayed retirement. We do this for those who: (1) are not disabled, (2) did not die before the model predicted their retirement or Social Security take-up, (3) retired or took up Social Security benefits before age 70 or the end of the projection period, and (4) are still in the labor force and not collecting Social Security benefits in 1993, the first year of DYNASIM projections. For example, in the “work one more year” scenario, if DYNASIM projects a worker to retire at age 60 and to begin receiving Social Security benefits at age 62, we force the worker to retire at age 61 and to take up Social Security benefits at age 63. In the “work five more years” scenario, we force the worker to retire at age 65 and to take up Social Security benefits at age 67. We then insert the worker’s pre-retirement earnings, indexed by wage growth, in each simulated extra year of work. We also shift the worker’s original post-retirement earnings to reflect his or her additional work effort. After adjusting the earnings and benefit take-up age, we let the model re-estimate pensions, Social Security benefits, and federal and state income taxes.

Working longer by itself may not close the gap between projected Social Security income and outlays, and Social Security benefit changes may induce additional work. Experimenting with alternative Social Security benefit structures, we conduct five policy simulations that differ from Social Security current law:

- **Pure Work Effect:** All nondisabled individuals delay retirement and benefit take-up and work one (or five) additional year(s). In this simulation, retirees receive Social Security benefits, which may stay constant or increase because of a delayed retirement credit or adjustment in the retirement earnings test, over a shorter period of time.
- **Pure Benefit Cut:** An across-the-board benefit cut that is unaccompanied by any change in work effort. This is represented by an increase in the Social Security NRA, which forces an actuarial reduction in the benefit at every age of retirement. While this simulation does not generate income for the Social Security Trust Funds, it does decrease costs substantially.
- **Partial Work, No Benefit Cut:** An increase in the Social Security early entitlement age (EEA) accompanied by an increase in the work effort of individuals who originally

retired before the new EEA.⁴ If the EEA increases by five years, then workers who used to retire at or before age 62 would retire five years later, those who used to retire between ages 63 and 66 would retire at age 67, and those who used to retire at age 67 or later would not change their retirement age. This simulation raises income slightly because workers who delay retirement continue to pay taxes. But it also raises costs slightly because no one receives a benefit cut, they just delay their Social Security take-up and benefits are reduced less for early retirement.

- **Partial Work with Benefit Cut:** An increase in the EEA and the NRA, accompanied by an increase in the work effort of individuals who originally retired before the EEA. This is similar to the previous simulation except that it decreases costs because the increase in the NRA is essentially a benefit cut.
- **Full Work with Benefit Cut:** Finally, an increase in the EEA and NRA, accompanied by an increase of similar magnitude in the work effort of all individuals. For example, if the EEA and NRA increase by one year, the work effort of all individuals, excluding the disabled, increases by one year. This simulation is identical to the previous one, but with a much larger impact since everyone increases work effort in addition to the EEA and NRA changes.

For each of these simulations, we examine how individual retirement annuity income and wealth, Social Security income and costs, and general revenues change compared to the baseline (no reform).⁵

Because we are interested in highlighting how an individual's work decision can impact his or her retirement income, each of these sources of wealth reflects only the wealth created by the individual. That is, we only include retired-worker benefits in the Social Security wealth calculation (i.e. we exclude Social Security auxiliary benefits), and pension wealth excludes survivors' benefits, inheritances, and benefits obtained through divorce. Each component of total retirement wealth is measured as the present discounted value (PDV) of the expected future

4. The early entitlement age, currently age 62, is the earliest age that individuals may take up Social Security benefits. However, annual benefits are then reduced to adjust for the fact that early retirees receive benefits over a longer period.

5. In order to analyze the change in net wealth and annual future consumption made possible by additional work, we first define total retirement wealth (TW) as the sum of Social Security wealth (SW), defined benefit pension wealth (DBPW), defined contribution account balances (DCPW), and earnings wealth (EW), less federal and state income taxes (IT) and payroll taxes (PT): $TW = SW + DBPW + DCPW + EW - IT - PT$.

stream of benefits or payments from age 50 until death, and then put into constant 2006 dollars. The computations assume a real interest rate of 2 percent. The measure shows net resources (from earnings, pensions, and Social Security) available to finance consumption after age 49, evaluated in the year 2006.

We also annuitize the value of retirement wealth to show how real annual consumption changes with additional work. We take the level of retirement wealth that accumulates over the individual's lifetime and divide it by the real annuity factor at age 50. The resulting value of the annuity shows how much could be consumed every year from age 50 until death, if the retiree chose to equalize real annual consumption after age 49.⁶ If retirees saved their additional wealth from working longer and annuitized *the additional amount* at retirement, their annual annuity payments would be much higher. To show this, we compute a second annuity, which is the sum of two different annuities—a baseline annuity purchased at age 50 and another purchased at the later of retirement age or Social Security take-up age. To compute the second annuity, we calculate the change in total net wealth between the baseline and alternative scenario, grow it from age 50 until the later of retirement or Social Security take-up age by a real interest rate of 2 percent, divide it by the real annuity factor that corresponds to that age, and add it to the baseline annuity.

At the macro level, we calculate the change in the Social Security deficit and in general revenue due to additional work. To do this we aggregate Social Security benefits and revenues over all individuals in the population and compare the projected total number of OASDI beneficiaries, the total benefits that will be paid to them, the total number of covered workers, and the total general revenue (payroll and income taxes) generated by their work under the baseline and alternative scenarios. For these analyses, we include both the individual's Social Security retired-worker and auxiliary benefits to represent more accurately the total costs to the system. We calculate the change in Medicare Hospital Insurance (HI) tax from additional work, but we exclude these funds in our Social Security deficit reduction calculations.

6. The annuity is price-indexed (inflation protected) and based on the average mortality by age, cohort, sex, race, and education. The real rate of return is 2 percent.

Description of DYNASIM

DYNASIM is a useful tool for gaining insights into the future retiree population and their retirement incomes.⁷ The model starts with a self-weighting sample of about 100,000 individuals from the 1990 to 1993 Survey of Income and Program Participation. DYNASIM ages this starting sample in yearly increments to 2050, using parameters estimated from longitudinal data sources. The model integrates many important trends and differentials in life course processes, including birth, death, schooling, leaving home, first marriage, remarriage, divorce, disability, work, and earnings. Important for this study, DYNASIM projects retirement age and Social Security take-up age. DYNASIM also simulates the major sources of retirement income—specifically Social Security benefits, pension income, income from assets, earnings, Supplemental Security Income (SSI), imputed rental income, and income from nonspouse co-resident family members. Finally, the most recent version of DYNASIM also includes federal and state income taxes, which are calculated using the income tax calculator developed by Jon Bakija (2005). This calculator accurately models current law taxes including the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), the AMT, and the taxation of Social Security benefits and pension income. (See the appendix for more detail on DYNASIM).

Increase in Income and Wealth for Individuals

Table 1 shows net retirement wealth and its components in our DYNASIM baseline. It also describes the change in wealth due to working both one and five years longer. In our baseline scenario, retirees who survive to 2049 and are receiving Social Security benefits accumulate an average net retirement wealth of \$625,976 (2006 dollars). This is the sum of \$199,378 in Social Security wealth, \$39,576 in defined benefit pension wealth, \$54,633 in retirement account balances (defined contribution pensions), and \$477,862 in earnings wealth, less \$110,982 in lifetime federal and state income taxes and \$34,491 in OASDI and HI payroll taxes. This

7. DYNASIM has been used to simulate how potential changes to Social Security will affect the future retirement benefits of at-risk populations (Favreault and Sammartino 2002; Favreault, Sammartino, and Steuerle 2002), how annuitization affects outcomes under a Social Security system with personal accounts (Uccello et al. 2003), the potential retirement consequences of rapid work effort growth among low-wage, single mothers in the late 1990s (Johnson, Favreault, and Goldwyn 2003), the implications of recent earnings inequality patterns for future retirement income (Smith 2002), and patterns of wealth accumulation and retirement preparedness (Butrica and Uccello 2004).

retirement wealth could support an annual consumption stream of \$26,570 per year from age 50 onward.⁸

If everyone delayed their retirement by just one year (Pure Work Effect), the average net retirement wealth would increase by \$31,897 and the average annuity at age 50 would increase by \$1,317 per year (5 percent). If retirees saved their additional wealth from working another year and annuitized it at retirement (e.g., 401[k] balances were left untouched until retirement), their annual annuity would increase by \$2,402 per year (9 percent) compared to the baseline. When workers work an additional five years, average net wealth increases \$160,992 (26 percent) compared to the baseline. Annuitized at retirement, this extra wealth would increase annual retirement income by \$14,888 per year—a 56 percent increase in retirement income compared to the baseline. While average Social Security wealth and retirement account balances increase with extra work, the big gains in net wealth for the individual come from his or her additional earnings. This additional wealth also generates additional taxes that can then be used to support more government spending for the retired population or for the population as a whole. The pure addition of extra work has a large positive impact on retirement income, at least as measured by potential consumption.

Table 2 shows the change in net wealth and the annual annuity under our five reform scenarios working an additional one year and five years compared to the baseline.⁹ The baseline and “Pure Work Effect” columns show the same results as in table 1.

Increasing the NRA without changing work behavior (Pure Benefit Cut) has a large negative impact on retirement wealth because it is essentially a benefit cut. With a one-year increase in the NRA and no work response, average net wealth would decline by \$12,169. The average annual annuity at age 50 would fall by \$515 (2 percent), and the average annual annuity at retirement would fall by \$936 (4 percent) compared to the baseline. With a five-year increase in the NRA, average net wealth would decrease by over \$60,000 and the average annuity at retirement would fall by 17 percent.

Next consider a delay in retirement but only by workers who originally retired before the new EEA. If the EEA were increased one year in this “Part Work No Benefit Cut” scenario, average net wealth would increase by \$21,685 and pay out an annual annuity that is \$882 higher

8. Reported numbers include Social Security beneficiaries in 2049 age 60 and older. We also ran these analyses for the cohorts born between 1964 and 1966 and found very similar results. For this reason, we present only the results of the larger sample.

9. Appendix A2 provides more details on how the sources of net wealth change with both one year and five years of additional work.

or even \$1,497 higher (if the additional annuity did not begin until retirement) than the baseline. If the EEA were increased five years and early retirees worked five more years, average net wealth would increase by \$132,716 and the annual annuity at retirement would increase by \$11,264 (42 percent). Note that what goes on here is that lifetime Social Security benefits go up (the actuarial adjustment is more than fair) slightly, some workers labor for an additional year and get more earnings, there are additional savings in defined contribution plans, and there are more taxes paid on the work.

In contrast to pure benefit cuts that decrease average net wealth, benefit cuts that are accompanied by additional work actually increase average net wealth. If only early retirees worked one more year but we increased the NRA one year (Part Work and Benefit Cut), net wealth would increase \$9,661. This would increase the average annuity at retirement by 2 percent. If every eligible worker changed his work behavior on top of a benefit cut (Full Work and Benefit Cut), net wealth would increase \$20,016 and the annuity at retirement would increase 5 percent. Under these scenarios, workers get the wealth benefit from the extra work, but the gain is partly offset by a reduction in Social Security benefits due to the benefit cut. The more workers who work longer, the larger the net gain.

If we focus just on the change in annuity income at retirement under our alternate reform scenarios, bigger increases in work effort yield bigger gains in retirement income. Reductions in Social Security benefits reduce retirement income, but benefit cuts in conjunction with additional work will ultimately lessen the size of any benefit cut needed to achieve solvency.

Lower-income workers get larger gains from additional work than do higher-income workers (see figure 2). Partly because of the progressive Social Security and income tax systems, lower-income workers keep a greater share of additional earnings because of lower tax rates compared with higher-income workers. Of course, since lower-income workers also tend to have somewhat higher mortality rates than higher-income workers, their additional earnings are spread over fewer years of remaining life. This mortality differential is captured in our calculated annuity income through education. While DYNASIM projects that the average annuity at retirement from one year of work, given no changes in Social Security policy, would increase 9 percent, workers in the bottom fifth of lifetime earnings distribution would get an average increase of 16 percent in their annuity at retirement from one year more work and a 98 percent increase from five more years of work. Benefits from work are still large for the top lifetime earners, but only about half as large as for the lowest earners.

Not all low-income workers can achieve this gain, of course. This paper does not examine all the policy options that one may also want to enact in conjunction with efforts to increase working years. But note that the relative gains increase well up the income scale, so that even the second richest quintile has a larger percentage increase in annual income than does the richest. Still, the gains are sizable in every quintile.

Substantial increases in work at older ages may be dependent on some amount of policy reform. Changing the symbolism of defining 62 as old age may itself have long-term effects if people begin to realize at that age they often have one-third of their adult lives on average remaining before them. Policy reform—whether it changes symbols or incentives or both—is likely to change work behavior (although we do not examine how much in this paper). As a bottom line, however, neither the “Pure Work Effect” nor the “Pure Benefit Cut” scenarios is realistic. Rather, reforms that include both work increases and benefit cuts are a more likely outcome.

Our examination of the potential change in retirement age brings to mind two very important problems that should be addressed. First, an increase in the retirement age for some individuals means an actual loss in defined benefits under current private plan practices. These net losses for individuals in some cases are offset by an equal and opposite net gain to employers. If one believes that employees could capture these gains, then the table understates the net gains to employees; either way it understates the net gains to the economy. Second, the actuarial adjustments in Social Security are quite generous as one moves into the future—in fact, they are more than actuarially fair from a benefit standpoint.¹⁰ Adjustments in retirement age need to be done in a way that avoids large unintended losses by relying on old formulas for what makes actuarial sense. For example, the “Pure Work Effect” scenario not only increases taxes paid by workers, it also bumps up their average lifetime benefits.

Effects of Additional Work on Social Security

This section examines the extent to which working longer can help make Social Security solvent. To do this, we aggregate Social Security benefits and revenues over all individuals in the population and compare the projected total number of OASDI beneficiaries, the total benefits

10. Given expected increases in life expectancy of future retirees, the actuary reduction for early benefits does not reduce benefits enough to compensate for the additional years of expected benefits. The reduction factors are based on life expectancy of earlier cohorts.

that will be paid to them, the total number of covered workers, and the total payroll taxes generated by their work under the baseline and alternative scenarios.

Under the DYNASIM baseline, Social Security expenditures on benefit payments will exceed income from OASDI payroll taxes beginning in 2023 (see figure 3).¹¹ By 2045, DYNASIM projects Social Security income to be \$3,791 billion and costs to be \$4,430 billion—a deficit of \$638 billion. If everyone worked one more year (Pure Work Effect), this would reduce the deficit by 2 percent (see table 3).¹² However, working five more years (Pure Work Effect) would reduce the deficit by 29 percent, still leaving a Social Security deficit of \$450 billion. Unfortunately, working longer by itself does not close the gap between projected Social Security income and outlays.¹³

Combining additional work with changes in Social Security policy has a much larger impact on the Social Security deficit than just working longer by itself. For example, if everyone delayed retirement by five years and, at the same time, both the EEA and NRA were increased by five years (Full Work and Benefit Cut), Social Security could remain solvent beyond 2049 (the last year in the projection period). The deficit in 2045 would be reduced by 159 percent to become a surplus of \$377 billion. Even under the “Part Work and Benefit Cut” scenario, where not everyone delays retirement, the deficit in 2045 would be reduced by 147 percent to become a surplus of \$299 billion. Increasing the NRA five years alone (Pure Benefit Cut) would achieve solvency, reducing the deficit by 138 percent to become a surplus of \$243 billion in 2045.

Even though delaying retirement by itself (Pure Work Effect) does not close the deficit, it does reduce it by 2 percent for one more year of work and by 29 percent for five more years of work. Thus, more work allows a much higher benefit level to be sustained (at any tax rate). The Social Security earnings from one additional year of work (\$568 billion) in 2045 are almost equal to the entire 2045 Social Security deficit projected under the baseline scenario. Also, the additional Social Security taxes generated by five years of work (\$360 billion) is more than half of the Social Security shortfall in 2045.

11. OCACT projects that Social Security outlays will first exceed revenues in 2017 (Board of Trustees 2005). The Congressional Budget Office projects this year to be 2020 (Congressional Budget Office 2005). Our estimates will differ from either of these sources because (1) DYNASIM does not project children’s Social Security benefits, (2) our measure of Social Security revenue includes only payroll taxes and excludes interest and taxes on benefits, and (3) there are small differences in lifetime earnings of workers and their spouses.

12. Appendix table A4 includes additional detail for both the one-year and five-year scenarios.

13. Of course, increasing work beyond five years may be enough to close the gap. But this policy seems unrealistic.

Figure 4 shows aggregate income and costs to the Social Security system under the baseline and alternate scenarios assuming workers delay retirement by 5 years. As the cost to income ratio illustrates, under the baseline, the year of insolvency is 2023. It moves to 2027 under the “Pure Work Effect” scenario, to 2025 under “Part Work Effect No Benefit Cut” scenario, and beyond 2049 under all other scenarios.

Effects of Additional Work on General Revenues

Additional work also increases general revenues through federal and state income taxes. While this extra revenue is not earmarked for Social Security, it does represent additional resources available to cover other government spending or to help avoid higher taxes. We add this additional revenue to our measure of deficit reduction to calculate the change in the unified deficit. If all eligible workers worked one more year (Pure Work Effect), general revenues would increase \$170 billion (see table 4).¹⁴ The extra general tax revenue combined with the \$10 billion Social Security deficit reduction (from table 3) would generate \$180 billion additional revenue—that is a 28 percent reduction in the baseline Social Security deficit, compared with only a 2 percent reduction when the extra general tax revenue is excluded. A benefit cut without any additional work (Pure Benefit Cut) also lowers the Social Security deficit, but because it produces less income tax revenue, it reduces the total reform savings.

The impact of increased general revenues would be substantially greater if everyone delayed retirement by five years. For example, under the “Pure Work Effect” scenario, the Social Security deficit would decline by 29 percent, but the unified deficit would decline by 159 percent—more than enough to pay promised Social Security benefits in 2045. In fact, accounting for the increase in general revenues, all of the five-year scenarios modeled would be solvent throughout the projection period (see figure 5).

While none of our one-year scenarios generate enough additional revenue to close the long-term Social Security deficit, all of the five-year scenarios are more than sufficient. The more we can encourage workers to delay retirement, the less we will have to reduce promised benefits to achieve solvency. (The net fiscal cost will depend on the net cost of the reform option used to induce the retirement change.) More work also increases retirement income through increased personal savings and a shorter spend-down period. The less we need to cut benefits to

14. Additional work also increases hospital insurance (HI) taxes. We do not include the additional HI revenue in our measure of revenue gains from work. The HI values are reported in appendix table A3.

close the spending gap, the more we can promise in Social Security. Since Social Security is still the most important asset for most retired households, additional work goes a long way toward ensuring retirees a comfortable retirement in the decades to come.

Looking narrowly at the Social Security system and ignoring the individual's additional earnings, at any given tax rate, additional work allows Social Security on average to pay a higher level of lifetime benefits (because there are more taxes to be shared). If people also stop increasing their number of years of benefits as their lifespans increase, their annual benefits in retirement can be maintained at a higher rate. As a corollary, for any Social Security system with any (reformed or unreformed) tax rate, a higher average retirement age (however induced) means higher lifetime benefits and much higher annual benefits than in a system with a lower retirement age.

Discussion

A number of policy changes have already occurred to encourage more work at older ages. These include the increase in the Social Security normal retirement age, the shift from defined benefit to defined contribution pensions, and the scaling back of retiree health insurance. However, these changes alone will probably not be enough. The revenue impact of additional work can significantly lessen the amount of benefit cuts necessary to make Social Security solvent. Any reform that increases work effort allows substantially higher levels of consumption for the population and higher Social Security benefits for retirees.¹⁵

Some options to consider that would encourage work at older ages include the following:

- Change the Social Security actuarial adjustments to boost the rewards for working longer and the penalties for retiring younger—even if actuarially neutral. For instance, one could consider decreasing early Social Security benefits and increasing delayed Social Security benefits. Note that distributional issues can be met several ways, such as providing a minimum benefit, or applying this type of actuarial adjustment only for marginal benefits above some minimum (so that only retirees with higher lifetime earnings were affected).
- Increases in the benefit entitlement age for both Social Security and Medicare. Indexing the NRA and the EEA to changes in life expectancy by itself would help reverse past

15. Although some reform options would require additional government spending, they would improve work incentives at older ages.

trends where, because people were receiving benefits earlier and earlier relative to expected death, smaller and smaller shares of total benefits were being paid to the truly old (e.g., those in the last ten years of their lives).

- Many incentives for early retirement are outside of the Social Security system. Regulatory barriers (e.g., from the tax code, the Employee Retirement Income Security Act of 1974 [ERISA], and the Age Discrimination in Employment Act [ADEA]) discourage the offering of phased retirement. For instance, some regulations prevent workers from collecting their defined benefit pensions while continuing to work for the plan sponsor, forcing workers to either retire or lose substantial pension wealth (Penner, Perun, and Steuerle 2002).
- The elimination of the requirement that Medicare serve as the secondary payer for workers with employer-sponsored coverage. The high cost of medical insurance for older workers discourages employers from retaining or hiring workers over age 65. Allowing Medicare (whatever the initial age of eligibility) to be the primary payer would lower employment costs and reduce the implicit tax rate faced by older workers, increasing work incentives at older ages.

Conclusion

Previous work has shown that the economic pressures of an aging population can be relieved considerably for particular hypothetical workers if they can be encouraged to delay retirement. The choice of retirement age is the most important portfolio choice most workers will make—far exceeding in importance such issues as whether to invest their 401(k)s in stocks or bonds. Working longer increases the net output and productivity of the economy, generates additional payroll and income tax revenue, and reduces the average number of years in which people receive retirement benefits. This report extends that previous research by demonstrating for the population as a whole just how much of a difference additional years of work can make for retirement income, for closing the gap in the Social Security deficit, and for producing other taxes that can be used to support the government as a whole.

We find that people could increase their annual consumption at older ages by 5 percent if they worked one more year and by 25 percent if they worked five more years—assuming an annuity purchased at age 50. The gains from working longer would be even greater if retirees saved their additional wealth and annuitized it at retirement—a 9 percent increase in

consumption from one more year of work and a 56 percent increase from five more years of work. Lower-income workers gain more from additional work than higher-income workers, but all workers gain.

The Social Security earnings generated from one additional year of work are almost equal to the entire 2045 Social Security shortfall (of benefits from taxes) projected under the baseline scenario. Also, the additional Social Security taxes generated by five years of work offset more than half of the Social Security shortfall in 2045. While working an additional five years reduces the Social Security deficit, it is not enough to completely erase it. However, combining additional work with a corresponding change in the NRA means that Social Security could remain solvent beyond 2049 (the last year in the projection period). Accounting for the federal and state income taxes generated from additional work, no other changes in Social Security policy would be needed for the system to remain solvent throughout the projection period. Interpolating between the one year and five year projections suggests that if workers would increase their work over the next 45 years roughly in proportion to their increase in life expectancy, they would likely increase payroll and income taxes by enough to wipe out almost any deficit in old age insurance payments between benefit payments and Social Security taxes currently collected.¹⁶ In this last case, we are not arguing that all those tax dollars should be devoted to Social Security, only how powerful the effect of additional work can be.

16. According to OCACT, the life expectancy in 2004 was 74.6 years for men and 79.6 years for women (Board of Trustees 2005). Under their intermediate assumptions, life expectancies in 2050 will increase by 4.8 years for men and 3.6 years for women.

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Table 1. Mean Baseline Respondent Wealth and Change from Additional Work (\$2006)

| | Baseline | Change from Baseline | |
|---|-----------------|-------------------------------|---------------------------------|
| | | Work One More Year | Work Five More Years |
| Social Security | \$199,378 | \$5,937 | \$28,864 |
| DB Pensions | 39,576 | -421 | -2,517 |
| DC Pensions | 54,633 | 2,028 | 10,859 |
| Earnings | 477,862 | 35,579 | 180,658 |
| Federal/State Income Taxes | 110,982 | 8,736 | 44,157 |
| Payroll Taxes | 34,491 | 2,489 | 12,715 |
| Total Net Wealth | 625,976 | 31,897 | 160,992 |
| Annual Annuity at Age 50 | 26,570 | 1,317 | 6,688 |
| Annual Annuity at Retirement | | 2,402 | 14,888 |
| %Change Total Net Wealth | | 5% | 26% |
| %Change Annual Annuity at Age 50 | | 5% | 25% |
| %Change Annual Annuity at Retirement | | 9% | 56% |

Notes: Based on 17,547 unweighted observations of persons who are alive in 2049 and retired and receiving Social Security benefits.

1. Annuity at age 50 is total net wealth divided by the real annuity factor at age 50.
2. Annuity at retirement is the change in total net wealth between the baseline and alternative scenario, grown from age 50 until the later of retirement or Social Security take-up age by a real interest rate of 2 percent, divided it by the real annuity factor that corresponds to that age, and added to the baseline annuity.

Source: The Urban Institute tabulations of DYNASIM3.

Table 2. Mean Respondent Wealth and Annuity Income in 2049 Under Current Law and Estimated Change Under Alternate Reform Scenarios (\$2006)

| | Change Due to the Reform Compared to Baseline | | | | | |
|--------------------------------|---|------------------|------------------|--------------------------|---------------------------|---------------------------|
| | Baseline | Pure Work Effect | Pure Benefit Cut | Part Work No Benefit Cut | Part Work and Benefit Cut | Full Work and Benefit Cut |
| Work One More Year | | | | | | |
| Net Wealth | \$625,976 | \$31,897 | -\$12,169 | \$21,685 | \$9,661 | \$20,016 |
| Annuity at Age 50 | 26,570 | 1,317 | -515 | 882 | 374 | 816 |
| Annuity at Retirement | | 2,402 | -936 | 1,497 | 554 | 1,449 |
| % Change Annuity at Age 50 | | 5% | -2% | 3% | 1% | 3% |
| % Change Annuity at Retirement | | 9% | -4% | 6% | 2% | 5% |
| Work Five More Years | | | | | | |
| Net Wealth | 625,976 | 160,992 | -60,256 | 132,716 | 73,331 | 100,344 |
| Annuity at Age 50 | 26,570 | 6,688 | -2,549 | 5,482 | 2,968 | 4,127 |
| Annuity at Retirement | | 14,888 | -4,617 | 11,264 | 5,948 | 8,993 |
| % Change Annuity at Age 50 | | 25% | -10% | 21% | 11% | 16% |
| % Change Annuity at Retirement | | 56% | -17% | 42% | 22% | 34% |

Notes: Based on 17,547 unweighted observations of persons who are alive in 2049 and retired and receiving Social Security benefits.

1. Annuity at age 50 is total net wealth divided by the real annuity factor at age 50.
2. Annuity at retirement is the change in total net wealth between the baseline and alternative scenario, grown from age 50 until the later of retirement or Social Security take-up age by a real interest rate of 2 percent, divided it by the real annuity factor that corresponds to that age, and added to the baseline annuity.

Source: The Urban Institute tabulations of DYNASIM3.

Table 3. Total Social Security Income, Cost, Social Security Deficit in 2045 by Reform Scenario (dollars in billions)

| | Change Due to the Reform Compared to Baseline | | | | | |
|---------------------------------|---|------------------|------------------|--------------------------|---------------------------|---------------------------|
| | Baseline | Pure Work Effect | Pure Benefit Cut | Part Work No Benefit Cut | Part Work and Benefit Cut | Full Work and Benefit Cut |
| Work One More Year | | | | | | |
| Social Security Earnings | \$30,575 | \$31,161 | \$30,575 | \$30,944 | \$30,944 | \$31,161 |
| Social Security Income | 3,791 | 3,864 | 3,791 | 3,837 | 3,837 | 3,864 |
| Social Security Cost | 4,430 | 4,492 | 4,250 | 4,511 | 4,309 | 4,317 |
| Social Security Deficit (OASDI) | 638 | 628 | 459 | 674 | 472 | 453 |
| Percent Change in Deficit | | -2% | -28% | 6% | -26% | -29% |
| Work Five More Years | | | | | | |
| Social Security Earnings | \$30,575 | \$33,481 | \$30,575 | \$32,873 | \$32,873 | \$33,481 |
| Social Security Income | 3,791 | 4,152 | 3,791 | 4,076 | 4,076 | 4,152 |
| Social Security Cost | 4,430 | 4,602 | 3,548 | 4,652 | 3,777 | 3,775 |
| Social Security Deficit | 638 | 450 | -243 | 576 | -299 | -377 |
| Percent Change in Deficit | | -29% | -138% | -10% | -147% | -159% |

Notes: Includes all surviving U.S. residents in 2045 (146,555 unweighted observations). Social Security Earnings includes only covered earnings below the taxable maximum. Social Security income includes OASI and DI taxes. Social Security cost includes OASI and DI adult benefits.

Source: The Urban Institute tabulations of DYNASIM3.

Table 4. Total Change in Income Tax, Social Security Deficit and Unified Deficit in 2045 by Reform Scenario (dollars in billions)

| | Pure Work Effect | Pure Benefit Cut | Part Work No Benefit Cut | Part Work and Benefit Cut | Full Work and Benefit Cut |
|--|------------------|------------------|--------------------------|---------------------------|---------------------------|
| Work One More Year | | | | | |
| Increase in Income Tax | 170 | -23 | 97 | 69 | 139 |
| Reduction in Social Security Deficit | 10 | 180 | -36 | 167 | 185 |
| Reduction in Unified Deficit | 180 | 157 | 62 | 236 | 324 |
| Percent Change in Social Security Deficit | -2% | -28% | 6% | -26% | -29% |
| Change in Unified Deficit as a Percent of the Social Security Deficit | -28% | -25% | -10% | -37% | -51% |
| Work Five More Years | | | | | |
| Increase in Income Tax | 824 | -110 | 610 | 473 | 684 |
| Reduction in Social Security Deficit | 188 | 882 | 63 | 938 | 1,015 |
| Reduction in Unified Deficit | 1,012 | 772 | 672 | 1,411 | 1,700 |
| Percent Change in Social Security Deficit | -29% | -138% | -10% | -147% | -159% |
| Change in Unified Deficit as a Percent of the Social Security Deficit | -159% | -121% | -105% | -221% | -266% |

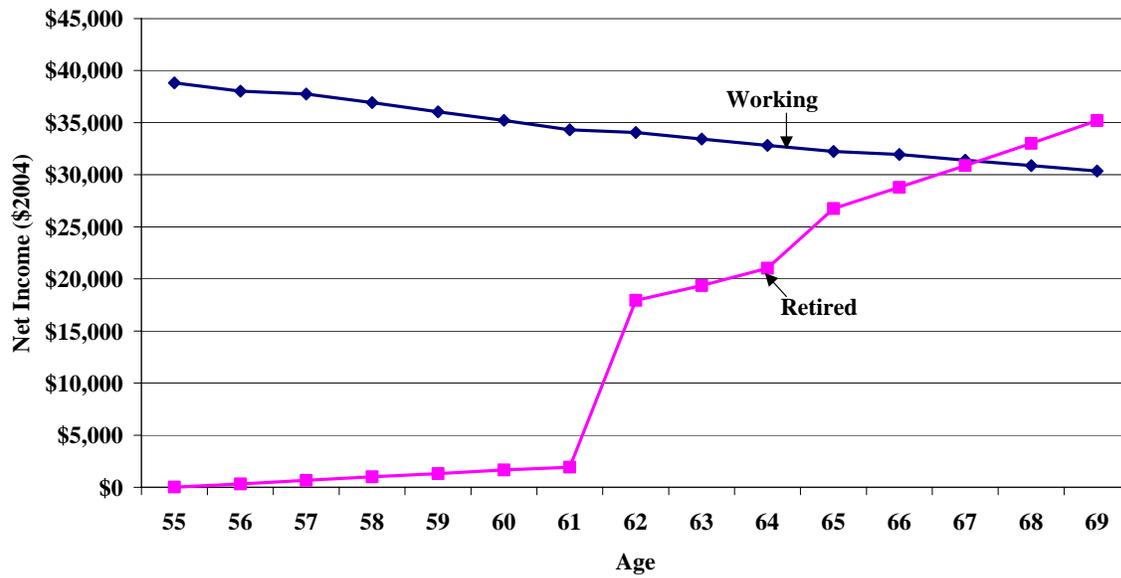
Notes: Percent change based on projected baseline Social Security deficit of \$638 billion in 2045.

Includes all surviving U.S. residents in 2045 (146,555 unweighted observations).

Income tax includes both federal and state income tax.

Source: The Urban Institute tabulations of DYNASIM3.

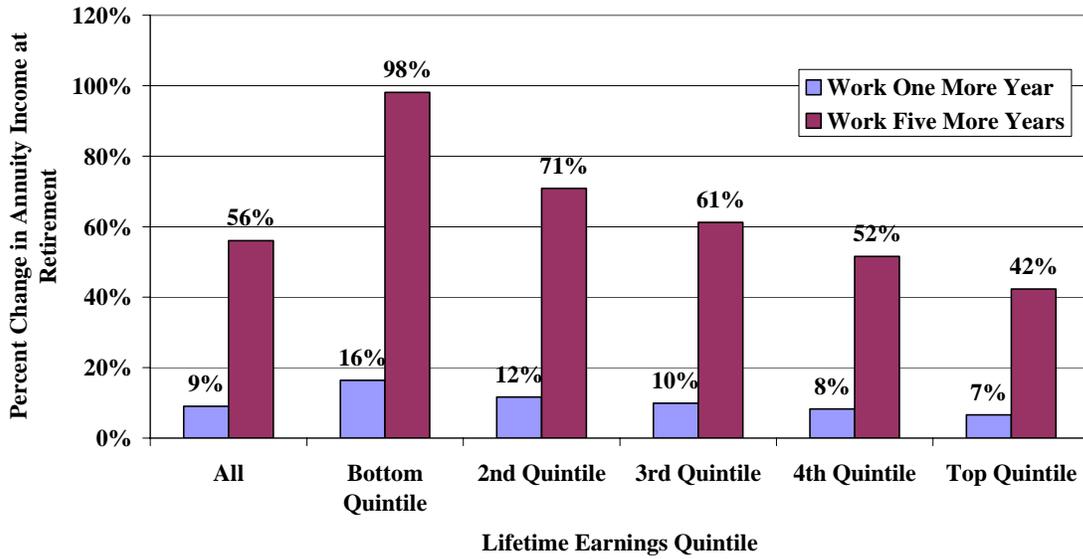
Figure 1. Net Income of a Hypothetical Worker by Age and Employment Status



Notes: Urban Institute calculations based on a representative single male worker in good health with a DC pension plan and no retiree health insurance. Dollar amounts are in \$2004. The worker makes a health insurance contribution for the employer plan while working. He buys nongroup private health insurance when retired before age 65 and a Medigap policy after age 65.

Source: Table 4 from Butrica et al. (2004).

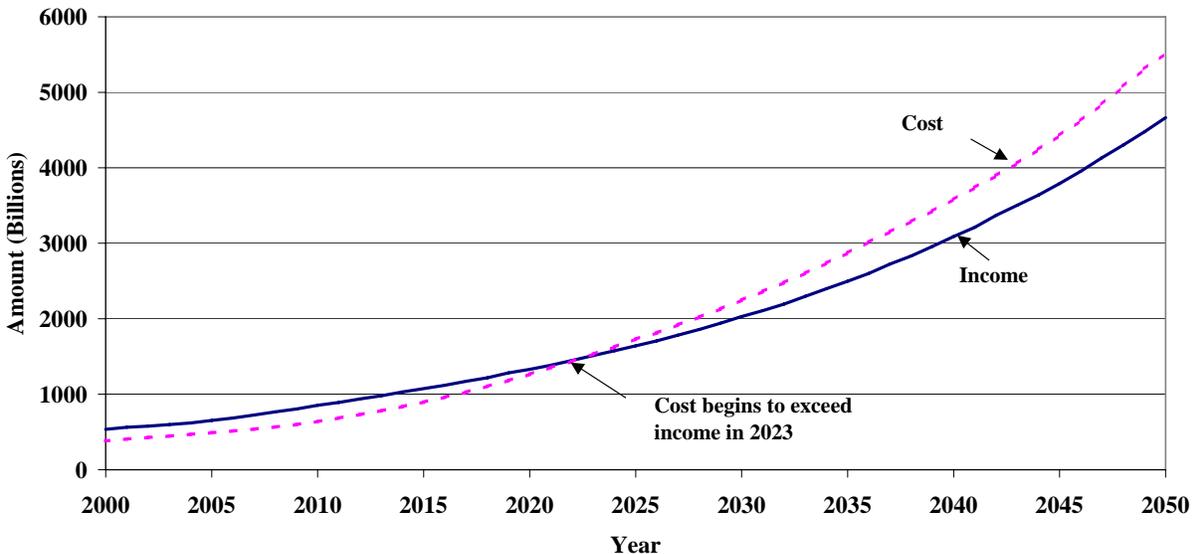
Figure 2. Percent Change from Baseline in Average Annuity Income at Retirement by Lifetime Earnings Quintile and Additional Work Effort



Notes: Based on 17,547 observations of persons who are retired and receiving Social Security benefits by 2049. Lifetime earnings are the average wage-adjusted individual earnings from age 22 to 62 in the baseline simulation.

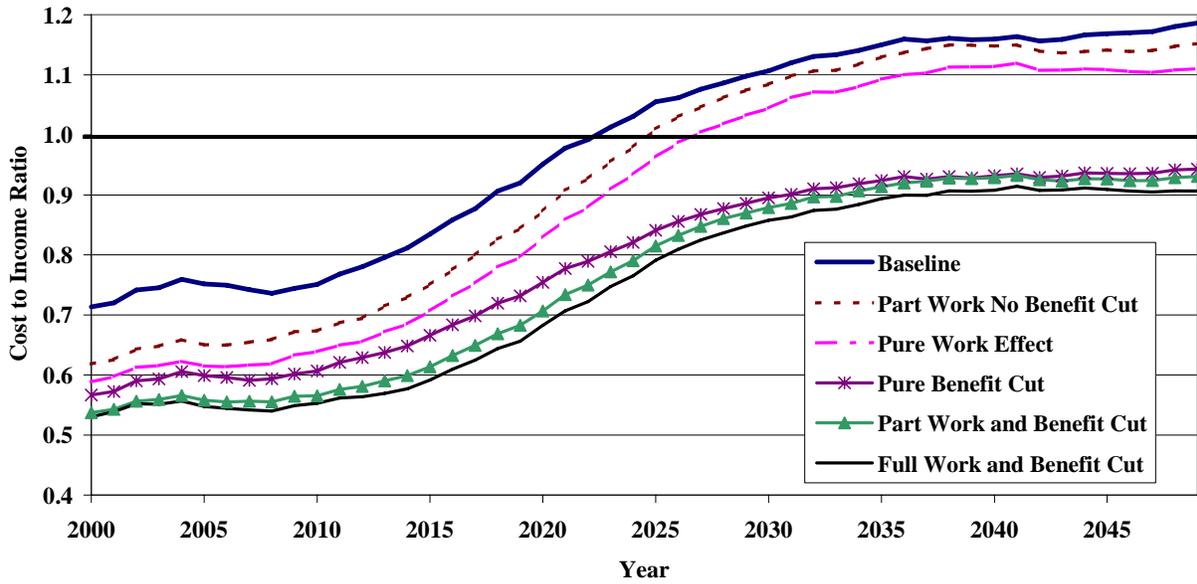
Source: The Urban Institute tabulations of DYNASIM3.

Figure 3. Aggregate Income and Costs to the Social Security System, Under the Baseline, 2000 to 2050



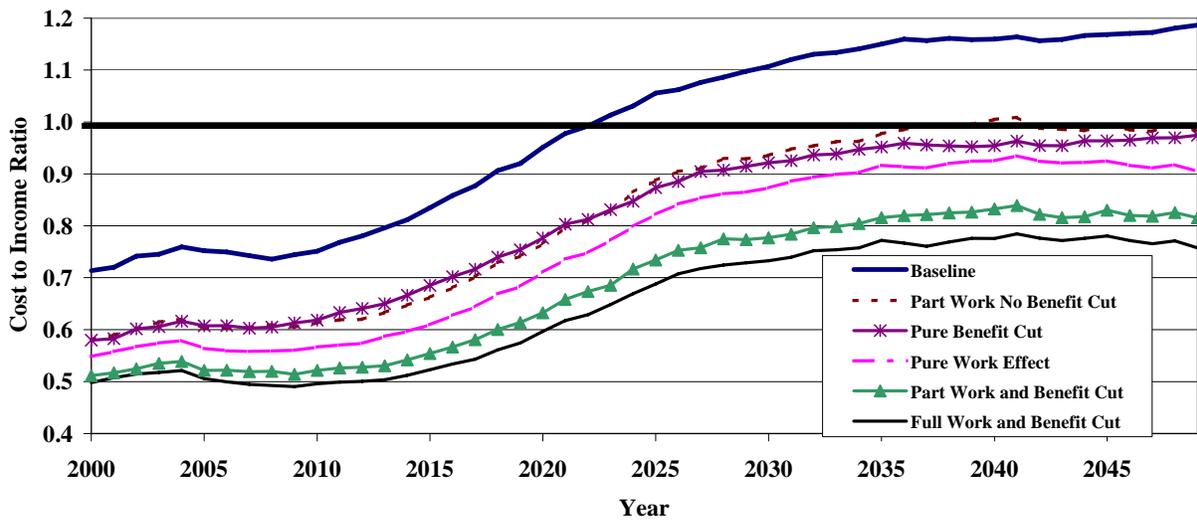
Source: The Urban Institute tabulations of DYNASIM3.

Figure 4. Social Security Cost to Income Ratio Under Various Working Five More Years Reform Scenarios, 2000 to 2049



Source: The Urban Institute tabulations of DYNASIM3.

Figure 5. Social Security Cost to Income Ratio Under Various Working Five More Years Reform Scenarios Including Additional Income Tax, 2000 to 2049



Source: The Urban Institute tabulations of DYNASIM3.

Appendix

Appendix table 1 summarizes the basic processes modeled in DYNASIM, along with the data on which the module's parameters are estimated. Favreault and Smith (2004) provide a fuller description of each of the modules used in DYNASIM. More details on the modules directly related to this report are provided below.

Sample

DYNASIM begins with a self-weighting sample of 103,072 individuals from the 1990–1993 Survey of Income and Program Participation (SIPP) data. The SIPP data provide starting values for age, sex, race, education, marital status, immigrant status, earnings, pension characteristics, financial asset, home equity, earnings, Social Security, and SSI.

Earnings

Projections of pension and Social Security wealth depend on earnings. DYNASIM has historic individual earnings from 1951 to 1992 and projected earnings from 1993 to 2050. These historical data are based on earnings records that are statistically matched from longitudinal earnings histories taken from the 1968–1994 PSID and the 1973 March Current Population Survey (CPS) matched to the Social Security Administration Summary Earnings Record.¹⁷ Projected labor supply and earnings are based on a complex set of regressions from the PSID and the National Longitudinal Survey of Youth (NLSY) and calibrated to 2005 Social Security Office of the Chief Actuary (OCACT) assumptions about future labor force participation and wage growth.

Taxes

DYNASIM has the capacity to estimate payroll taxes, as well as state and federal income taxes. The DYNASIM tax calculator accurately models current law taxes including EGTRRA, JGTRRA, the AMT, and the taxation of Social Security benefits and pension income. The tax calculator also simulates future tax law. For short-term projections (through about 2010), it holds constant the current law tax rates and adjusts the brackets as appropriate for expected inflation. It holds the Social Security taxation thresholds at their current law values, since these are not

¹⁷ Smith, Scheuren, and Berk (2001) show that these earnings histories match up quite well with actual earnings histories that are available on a confidential basis at the Social Security Administration.

indexed for inflation. The calculator also price indexes the provisions of the alternative minimum tax (AMT) beyond the current period, even though these provisions are not currently indexed. Without this adjustment, many middle-class taxpayers would end up paying the AMT (Burman, Gale, and Rohaly 2003). Since wages are expected to increase faster than prices, the tax calculator indexes the brackets and provisions of the AMT to wages instead of prices for the long-term projections. Doing this will avoid real-bracket creep and prevent the ratio of taxes to gross domestic product (GDP) from rising steadily over time. It also continues to hold the Social Security taxation thresholds at their current law values.

Pensions

DYNASIM projects pension amounts in defined benefit (DB) plans and defined contribution (DC) plans, as well as from IRA and Keogh plans. Pensions are based on an individual's entire work history (real and simulated) up to the projected retirement date. Baseline information regarding pension coverage on current and past jobs is based on SIPP self-reports. To impute future job changes and pension coverage on future jobs, DYNASIM incorporates data on synthetic work histories from the Policy Simulation Group's PENSIM model, developed for the Department of Labor, Pension and Welfare Benefits Administration.¹⁸

DYNASIM next projects pension benefits from past, current, and future jobs. In general, DB plan benefits are projected using pension plan formulas from the Pension Benefit Guarantee Corporation (PBGC)'s Pension Insurance Modeling System (PIMS). DC account balances are projected using self-reported information on the SIPP regarding account balances and contribution rates, as well as asset allocations and future contribution rates that vary by age according to EBRI/ICI data on 401(k) asset allocations (VanDerhei et al. 1999). The proportion of initial contributions and balances allocated to equities varies by age category. Then, every five years, the model rebalances the portfolios according to the allocation strategy for the individual's attained age category. Subsequent contributions are allocated to match the allocation strategy of the attained age, if different.

DYNASIM accumulates DC account balances assuming a Consumer Price Index (CPI) growth rate of 3.00 percent (the growth rate assumed by OCACT), a real rate of return for stocks of 6.50 percent, and a real rate of return for bonds of 3.30 percent. One percent is subtracted from each of the stock and bond real rates of return to reflect administrative costs. Investment experience varies by individual and by year by setting the rates stochastically (assuming a standard deviation of 17.28 percent for stocks and 2.14 percent for bonds).

¹⁸ See Holmer, Janney, and Cohen (2006) for more detail on the PENSIM model.

The SIPP also includes information regarding IRA/Keogh account balances and contributions. Similar to DC plans, IRA/Keogh account balances are accumulated to the retirement date, along with any new contributions and interest earnings. IRA/Keogh contribution rates are allowed to vary over time by age and earnings, using the same method used for DC plans. IRA/Keogh contributions are capped according to the legal limits that vary by year. IRA/Keogh assets are allocated the same way as DC assets and rates of return are set stochastically using the same method as that used for DC plans. Only those with IRA/Keogh coverage at the time of the SIPP interview have IRAs/Keoghs. No new IRA/Keogh participation is simulated in DYNASIM.

Social Security Benefits

DYNASIM also includes a detailed Social Security benefit calculator that uses earnings and marital histories to estimate Social Security benefits—either retired-worker, spouse, or survivor benefits. The current benefit calculator is based on the 2005 OCACT assumptions about future price and wage growth. In each year, from the projected year of first benefit receipt until the projected year of death, DYNASIM computes a respondent's Social Security benefit that reflects his or her earnings and marital history at that point in time. The calculator first establishes benefit eligibility based on personal characteristics such as age, number of covered quarters, disability status, marital status, and length of marriage. For those who qualify, the model computes Social Security benefits—either retired worker, spouse, divorced spouse, or survivor benefits. The calculator then checks an individual's take-up age against his or her NRA, reducing benefits for those who retire before their NRA and increasing benefits for those who retire later. Social Security estimates are based on the assumption that current-law benefits will be payable throughout the projection period. However, the Social Security OASDI Trust Funds are projected to be exhausted by 2041 and OCACT estimates that benefits would need to be reduced by 12.8 percent starting in 2005 in order for the trust funds to remain solvent (Board of Trustees 2005). If the benefit cuts are delayed, the average percentage reduction would need to be larger. Our Social Security wealth estimates are based on the assumption that future retirees will receive the current law benefits they were promised, not the benefits that current trust fund receipts will finance in the long run. But the model is capable of simulating the effects of alternative benefit levels.

Appendix Table 1. Summary of Core Processes Modeled in DYNASIM

| Process | Data | Form and predictors |
|---------------------------|--|---|
| Birth | <i>Estimation:</i> NLSY (1979–94); VS; <i>Target:</i> OCACT | 7-equation parity progression model; varies on the basis of marital status; predictors include age, marriage duration, time since last birth; uses vital rates after age 39; sex of newborn assigned by race; probability of multiple birth assigned by age and race |
| Death | <i>Estimation:</i> NLMS (1979–81); VS (1982–97); <i>Target:</i> OCACT | 3 equations; time trend from Vital Statistics 1982–1997; includes socioeconomic differentials; separate process for the disabled based on age, sex, age of disability onset, and disability duration derived from Zayatz (1999) |
| Schooling | NLSY (1979–94), CPS (Oct. 1995) | 10 cross-tabulations based on age, race, sex, and parent’s education |
| Leaving Home | NLSY (1979–94) | 3 equations; family size, parental resources, and school and work status are important predictors |
| First Marriage | NLSY (1979–93) | 8 equations; depends on age, education, race, earnings, presence of children (for females); uses vital rates at older ages |
| Spouse Selection | | Closed marriage market (spouse must be selected from among unmarried, opposite-sex persons in the population); match likelihood depends on age, race, education |
| Remarriage | VS (1990) | Table lookups, separate by sex for widowed and divorced |
| Divorce | PSID (1985–93) | Couple-level outcome; depends on marriage duration, age and presence of children, earnings of both spouses |
| Labor Supply and Earnings | <i>Estimation:</i> PSID (1980–93); NLSY (1979–89); <i>Target:</i> OCACT (LFP, wage/price growth) | Separate participation, hours decisions, wage rates for 16 age-race-sex groups; all equations have permanent and transitory error components; some wage equations correct for selection bias; key predictors include age splines, marital status, number and ages of children, job tenure, education level, region of residence, disability status, schooling status, unemployment level, and age spline–education-level interactions |
| Disability | SIPP (1990) | Separate entry (by sex)/exit (pooled) equations; include socio-economic differences (education, marital status, earnings history) |
| DI Take-up | SIPP (1990–93) | 2 separate equations (by sex) predict take-up of those eligible for disabled worker benefits (ages 19 through the normal retirement age); key predictors include age, disability status, education, marital status, recent earnings |

(continued)

Appendix Table 1. Summary of Core Processes Modeled in DYNASIM (cont.)

| Process | Data | Form and predictors |
|---------------------------------|--|---|
| Pensions (DB, DC, IRAs, Keoghs) | BLS (1999–2000); EBRI/ICI; SIPP (1990–93); PENSIM (PSG) and PIMS models (PBGC) | Uses SIPP self-reports on past and current pension coverage with job changes and future coverage simulated using PENSIM; uses PIMS for DB formulas (with separate procedure for DBs from government jobs); DC balances projected using SIPP self-reports of account balances and contribution rates and EBRI/ICI data asset allocations and contribution rates for new participants |
| Wealth | PSID (1984–94); SIPP (1990–93) | 4 random-effects models for ownership/value given ownership separately for housing and non-housing wealth; additional models for spend-down after first OASDI receipt; key predictors include age, race, marital status, family size, birth cohort, dual-earner status, pension coverage, recent earnings |
| OASI Take-up | SIPP (1990–93) | Eligibility is deterministic; 3 separate equations (separate for workers by lagged earnings, and auxiliary beneficiaries) predict take-up of those eligible for retired worker benefits (ages 62 and older); key predictors include age, disability status, education, marital status, recent earnings, pensions, lifetime earnings, and spouse characteristics; take-up of survivor benefits at 60 and 61 is deterministic (i.e., mandatory if earnings are below the exempt amount) |
| OASDI Benefits | Rule-based | Sophisticated calculator incorporates entire work and marriage histories, auxiliary benefits for spouses/survivors and former spouses, and the retirement earnings test. |
| SSI Benefits | SIPP (1990–93) | Eligibility is deterministic; 2 equations predict take-up of the aged; key predictors include demographics, state supplement, resources |
| Living Arrangements of the Aged | SIPP (1990–93) | Logistic regression that considers health, resources, and kin availability (number of children ever born); resources of co-residing family members are imputed using donor families sampled from current co-residing aged individuals in SIPP. |
| Immigration | PUMS 1980, 1990, 2000; INS yearbook 2001 | Adds target number of immigrants based on sex, country of origin, and age at immigration derived from Dowhan and Duleep (2002) |

BLS = Bureau of Labor Statistics; CPS = Current Population Survey; EBRI = Employee Benefits Research Institute; DB = defined benefit; DC = defined contribution; DI = Disability Insurance; ICI = Investment Company Institute; INS = U.S. Immigration and Naturalization Service; LFP = labor force participation; NLMS = National Longitudinal Mortality Study; NLSY = National Longitudinal Survey of Youth; OASDI = Old-Age, Survivors, and Disability Insurance; OCACT = Office of the Chief Actuary intermediate assumptions; PBGC = Pension Benefit Guarantee Corporation; PIMS = Pension Insurance.

Table A2. Mean Respondent Wealth and Annuity Income in 2049 Under Current Law and Estimated Change Under Alternate Reform Scenarios (\$2006)

| | Baseline | Pure Work Effect | Pure Benefit Cut | Part Work No Benefit Cut | Part Work and Benefit Cut | Full Work and Benefit Cut |
|--|-----------------|-------------------------|-------------------------|---------------------------------|----------------------------------|----------------------------------|
| Work One More Year | | | | | | |
| Social Security | 199,378 | 205,315 | 185,796 | 203,055 | 189,563 | 191,804 |
| DB Pensions | 39,576 | 39,155 | 39,576 | 39,550 | 39,550 | 39,155 |
| DC Pensions | 54,633 | 56,661 | 54,633 | 55,760 | 55,760 | 56,661 |
| Earnings | 477,862 | 513,441 | 477,862 | 501,860 | 501,860 | 513,441 |
| Federal/State Income Taxes | 110,982 | 119,718 | 109,569 | 116,438 | 114,970 | 118,089 |
| Payroll Taxes | 34,491 | 36,981 | 34,491 | 36,126 | 36,126 | 36,981 |
| Total Net Wealth | 625,976 | 657,873 | 613,807 | 647,661 | 635,637 | 645,991 |
| Annual Annuity at Age 50 | 26,570 | 27,887 | 26,056 | 27,452 | 26,944 | 27,386 |
| Annual Annuity at Retirement | | 28,972 | 25,635 | 28,067 | 27,124 | 28,020 |
| Percent Change in Net Wealth | | 5.1% | -1.9% | 3.5% | 1.5% | 3.2% |
| Change Total Net Wealth | | 31,897 | -12,169 | 21,685 | 9,661 | 20,016 |
| Change Annual Annuity at Age 50 | | 1,317 | -515 | 882 | 374 | 816 |
| Change Annual Annuity at Retirement | | 2,402 | -936 | 1,497 | 554 | 1,449 |
| Work Five More Years | | | | | | |
| Social Security | 199,378 | 228,242 | 132,816 | 222,480 | 154,651 | 158,694 |
| DB Pensions | 39,576 | 37,060 | 39,576 | 40,610 | 40,610 | 37,060 |
| DC Pensions | 54,633 | 65,492 | 54,633 | 62,095 | 62,095 | 65,492 |
| Earnings | 477,862 | 658,520 | 477,862 | 623,259 | 623,259 | 658,520 |
| Federal/State Income Taxes | 110,982 | 155,139 | 104,676 | 145,156 | 136,712 | 146,239 |
| Payroll Taxes | 34,491 | 47,207 | 34,491 | 44,596 | 44,596 | 47,207 |
| Total Net Wealth | 625,976 | 786,968 | 565,720 | 758,692 | 699,307 | 726,320 |
| Annual Annuity at Age 50 | 26,570 | 33,258 | 24,021 | 32,052 | 29,538 | 30,698 |
| Annual Annuity at Retirement | | 41,458 | 21,953 | 37,834 | 32,518 | 35,563 |
| Percent Change in Net Wealth | | 26% | -10% | 21% | 12% | 16% |
| Change Total Net Wealth | | 160,992 | -60,256 | 132,716 | 73,331 | 100,344 |
| Change Annual Annuity at age 50 | | 6,688 | -2,549 | 5,482 | 2,968 | 4,127 |
| Change Annual Annuity at Retirement | | 14,888 | -4,617 | 11,264 | 5,948 | 8,993 |

Notes: Based on 17,547 unweighted observations of persons who are alive in 2049 and retired and receiving Social Security benefits.

1. Annuity at age 50 is total net wealth divided by the real annuity factor at age 50.

2. Annuity at retirement is the change in total net wealth between the baseline and alternative scenario, grown from age 50 until the later of retirement or Social Security take-up age by a real interest rate of 2 percent, divided it by the real annuity factor that corresponds to that age, and added to the baseline annuity.

Source: The Urban Institute tabulations of DYNASIM3.

**Table A3. Aggregate Impact of Working One and Five Years Longer on Social Security and General Revenues
(Population in Millions and Amounts in Billions)**

| | Baseline | Pure Work Effect | Pure Benefit Cut | Part Work No Benefit Cut | Part Work and Benefit Cut | Full Work and Benefit Cut |
|--|-----------------|---------------------------------|---------------------------------|---|--|--|
| Work One More Year | | | | | | |
| Total Population | 369 | 369 | 369 | 369 | 369 | 369 |
| Covered Worker Population | 188 | 191 | 188 | 190 | 190 | 191 |
| Retiree Population | 85 | 82 | 85 | 84 | 83 | 82 |
| Total Earnings | 32,284 | 32,929 | 32,284 | 32,706 | 32,706 | 32,929 |
| Taxable Earnings | 30,575 | 31,161 | 30,575 | 30,944 | 30,944 | 31,161 |
| OASI Tax | 3,241 | 3,303 | 3,241 | 3,280 | 3,280 | 3,303 |
| DI Tax | 550 | 561 | 550 | 557 | 557 | 561 |
| Total OASDI Tax | 3,791 | 3,864 | 3,791 | 3,837 | 3,837 | 3,864 |
| Total HI Tax | 887 | 904 | 887 | 897 | 897 | 904 |
| Total Income Tax | 8,438 | 8,608 | 8,414 | 8,535 | 8,507 | 8,577 |
| Total Revenue (OASDI+ΔIncome Tax) | 3,791 | 4,034 | 3,768 | 3,935 | 3,906 | 4,003 |
| Total Benefits | 4,430 | 4,492 | 4,250 | 4,511 | 4,309 | 4,317 |
| Social Security Deficit (OASDI Tax) | 638 | 628 | 459 | 674 | 472 | 453 |
| Social Security Deficit (Total Revenue) | 638 | 458 | 482 | 577 | 403 | 314 |
| Work Five More Years | | | | | | |
| Total Population | 369 | 369 | 369 | 369 | 369 | 369 |
| Covered Worker Population | 188 | 203 | 188 | 199 | 199 | 203 |
| Retiree Population | 85 | 71 | 84 | 74 | 73 | 70 |
| Total Earnings | 32,284 | 35,454 | 32,284 | 34,823 | 34,823 | 35,454 |
| Taxable Earnings | 30,575 | 33,481 | 30,575 | 32,873 | 32,873 | 33,481 |
| OASI Tax | 3,241 | 3,549 | 3,241 | 3,485 | 3,485 | 3,549 |
| DI Tax | 550 | 603 | 550 | 592 | 592 | 603 |
| Total OASDI Tax | 3,791 | 4,152 | 3,791 | 4,076 | 4,076 | 4,152 |
| Total HI Tax | 887 | 971 | 887 | 953 | 953 | 971 |
| Total Income Tax | 8,438 | 9,262 | 8,328 | 9,047 | 8,911 | 9,122 |
| Total Revenue (OASDI+ΔIncome Tax) | 3,791 | 4,976 | 3,681 | 4,686 | 4,549 | 4,836 |
| Total Benefits | 4,430 | 4,602 | 3,548 | 4,652 | 3,777 | 3,775 |
| Social Security Deficit (OASDI Tax) | 638 | 450 | -243 | 576 | -299 | -377 |
| Social Security Deficit (Total Revenue) | 638 | -374 | -133 | -34 | -773 | -1,061 |

Notes: Includes all surviving U.S. residents in 2045 (146,555 unweighted observations).

Total Revenue includes OASI, DI, and the change in federal and state income tax. HI tax is not included.

Source: The Urban Institute tabulations of DYNASIM3.