

Prospects for the Social Safety Net for Future Low Income Seniors

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Older Americans have benefited substantially from the two key government entitlement programs, Social Security and Medicare, and from Supplemental Security Income and Medicaid, which are specifically targeted on the very poor. But the gains from these programs and from other sources of retirement security have slowed over time and low and modest income seniors in the future likely will not experience substantial improvements in financial security unless these public programs are expanded in ways that do not now seem likely. Indeed, people reaching the age of 65 who have had only low incomes over their lifetimes will continue to suffer from a lack of financial resources, and others with modest incomes may face declining economic status, particularly when the costs of health care are taken into account. It is essential to look at both health and income security issues since they go hand in hand.

Prospects for Future Income Growth

Projecting trends from the past, some advocates of lower entitlement spending have argued that the need for a safety net for older Americans will continue to decline. Indeed, substantial progress was made for seniors in lowering the rates of poverty and increasing living standards from the end of World War II through the middle of the 1990s (Clark et al 2004, Moon 2006). But, progress has largely stalled and a number of trends indicate that we will likely see reverses in well-being for at least the third of seniors with the lowest incomes.

Moreover, the overall statistics on the income of older Americans can be misleading in at least two ways. Increases in average incomes for seniors that have continued in this new century mask the situation of those who come to retirement with more limited resources. The gains

largely accrue to those with higher than average incomes. Second, any focus on growth in incomes over time needs to note that the statistics on the “over 65” population show income growth faster than that which occurs for any single individual. For example, median income for persons aged 65 to 69 in 2001 (adjusted for inflation) was \$17,761. This age group had a median income of \$20,645 in 2006, implying higher living standards. But that is because of new entries into that age group. Instead, consider the group aged 70 to 74—the same cohort of people who were 65 to 69 in 2001. Median income for that group was \$17,150—representing a modest decline in the incomes of the age group initially captured by the data in 2001. Indeed, income often declines as people age (Purcell 2007). They may spend some of their assets or lose various other sources of income over time.

Why are the prospects so guarded for the future of many older Americans? First, increasing inequality in earnings over time has meant that earnings growth (which forms the basis for the Social Security benefits that people ultimately receive) has been slower for low income workers than wages in general. This helps explain why receipt of Social Security has done less in recent years to reduce poverty than in the past when wage growth was higher. Once an individual begins receiving benefits, the monthly amount grows only with the rate of inflation over time. For those who rely heavily or exclusively on Social Security, income does not decline, but it fails to keep pace with other changes that have traditionally led to higher standards of living over time in the United States. Social Security accounts for more than 81 percent of the incomes of the half of older Americans with the lowest incomes (Purcell 2007). For this reason, most people who begin retirement with incomes below or near poverty remain at that level for the rest of their lives. Their incomes are largely fixed over time.

New retirees will be modestly better off each year, however, as compared to earlier age groups. One proxy for growth in well-being for beneficiaries is captured by the growth over the relevant periods in Social Security benefits for an average worker retiring at the normal retirement age (which for the future means retiring later over time). For low income individuals, growth in Social Security is likely to be a good indicator because of the large share that Social Security comprises of income. Social Security growth over the period between 2007 and 2030 is expected to rise by 29.8 percent (Board of Trustees 2007b) as each new group of individuals retires. This is measured in constant 2007 dollars, meaning that the general rate of inflation is taken into account. The higher Social Security amounts reflect the wage growth that individuals achieve over time--which translates into higher Social Security benefits.

But remember also that in Social Security, the age of “normal retirement” is rising from 65 to 67. That is, each year those who wish to get full Social Security benefits must work longer than in the past. If instead individuals in 2030 choose to retire at age 65, the rate of growth after controlling for inflation will only be 18.2 percent because their benefits will be reduced as a result of retiring “early.”

The challenges are different for those who also have income from pensions or assets to supplement Social Security. This particularly affects those with higher incomes, but a number of low income retirees are also affected since in the past they also benefited from access to pension coverage. For example, modest income retirees who worked in industries that traditionally provided generous benefits received pensions that raised their incomes. While pension may still grow in real terms over time, changes in the private sector have created a number of barriers to what had traditionally been a key source of growth in income security. For example, many workers change jobs more frequently than in the past at the same time that employers have

increased requirements to qualify for pensions, thus reducing their opportunities for obtaining retiree benefits. And as the generosity of pensions decline, the modest income group is more likely to be at risk. That is, many individuals with modest incomes reach retirement after periods out of the labor force that restrict their ability to accumulate pensions or savings that are so essential to supplementing Social Security.

For future retirees, pensions are more likely to be based on defined contribution rather than defined benefit plans—and hence depend upon individuals' willingness and ability to contribute consistently over time and not withdraw contributions when they change jobs. Defined contribution plans usually require a contribution by the employee that is matched in some way by the employer. This creates a barrier for workers whose incomes are barely enough to maintain a reasonable standard of living during their working years. Consequently, people whose salaries are low or moderate are less likely to participate in employer pensions, even when they are offered.

Further, employers are shifting the risk of pension inadequacy to individuals. Under a defined benefit approach, it is the employer's responsibility to increase contributions into the pension funds to make up for periods of poor economic performance. In contrast, a defined contribution system leaves individuals at risk for market losses. A prolonged period of economic downturn (or poor individual investment choices) during the individual's working years will translate directly into lower income in retirement.

Consequently, a number of analysts have indicated that the "golden age" of pensions has come and gone for America's seniors. Indeed, one of the indicators used to capture the readiness of individuals for retirement shows that risks of having too little income have grown considerably since the 1990s (Munnell et al. 2007a). In addition to the challenges of a changing

pension environment, returns on investments have slowed, and life expectancy (which increases the demands on these resources) has grown. These changes began some time ago, but will begin showing up in larger and larger numbers in the incomes of the nearly retired in the near future.

Another important source of economic well-being is savings, and again, lower income persons are more likely to reach retirement with low levels of savings. Savings tend to be even more unequally spread across the population than income. For those in the bottom fourth of the income distribution (with incomes of \$10,530 or less in 2006), pensions and asset incomes together account for just 11 percent of income (Purcell 2007). Ironically, those with high pensions also tend to have higher savings.

For these reasons, it is likely that standards of living for low income retirees will rise only modestly over time, if at all (assuming no change in Social Security policy), while some older Americans with modest incomes during their working years will face the prospect of declining living standards over time as pensions become less generous. As this second group with modest incomes approaches retirement with fewer savings and pension holdings, they may be less equipped to remain longer in the labor force if they are in physically demanding jobs and have lower skills than their higher income counterparts.

Further, savings and lump sum payments from defined contribution plans need to last for the rest of a person's lifetime—creating challenges in planning for reasonable rates of spending in the early retirement years and avoiding major problems such as a health crisis for the individual (or family members) that can wipe out even relatively generous savings. Retirees need to plan carefully for use of resources unless they convert these assets into annuities. Again, this is a challenging task for those retirees who are living modestly and may have to deplete a greater share of their savings to meet any one crisis.

Considering Issues of Risk

Also important for considering the future is the issue of increased financial risk on older Americans. That is, to the extent that income sources are based on individual decisions and behavior, there is less protection against untoward events. For example, poor individual decisions regarding investments in defined contribution pension plans, or shocks to the market—such as the recent housing credit problems that are beyond the control of individuals—can create considerable swings in returns that can be expected over time from savings or defined contribution plans. Because Social Security dominates the sources of income for the poor and near poor, their *risks* have grown less rapidly over the past decade, although they have not benefited from any major growth in living standards.

While everyone is vulnerable to general changes in economic conditions, risks are likely still greater for those with lower incomes but above the level where Social Security dominates. If the amount of accumulated savings and holdings in pension plans are small, individuals are less likely to have access to financial advice or be able to diversify holdings in ways that might offer more protection. People living at the margin may not be able to resist using the funds up rapidly over time. Those with modest incomes and a stable earnings history in the past likely would have been better off if covered by a defined benefit pension. Many lower income families in earlier years experienced an improvement in their economic status because of such pensions (Clark et al. 2004). But that cannot be expected to last into the future.

The potential for a decline in economic status at retirement for modest income workers as a result of poor investment choices, or demands on their assets before or early in retirement is a very real issue for the future. Information on current workers indicates no signs of reductions in

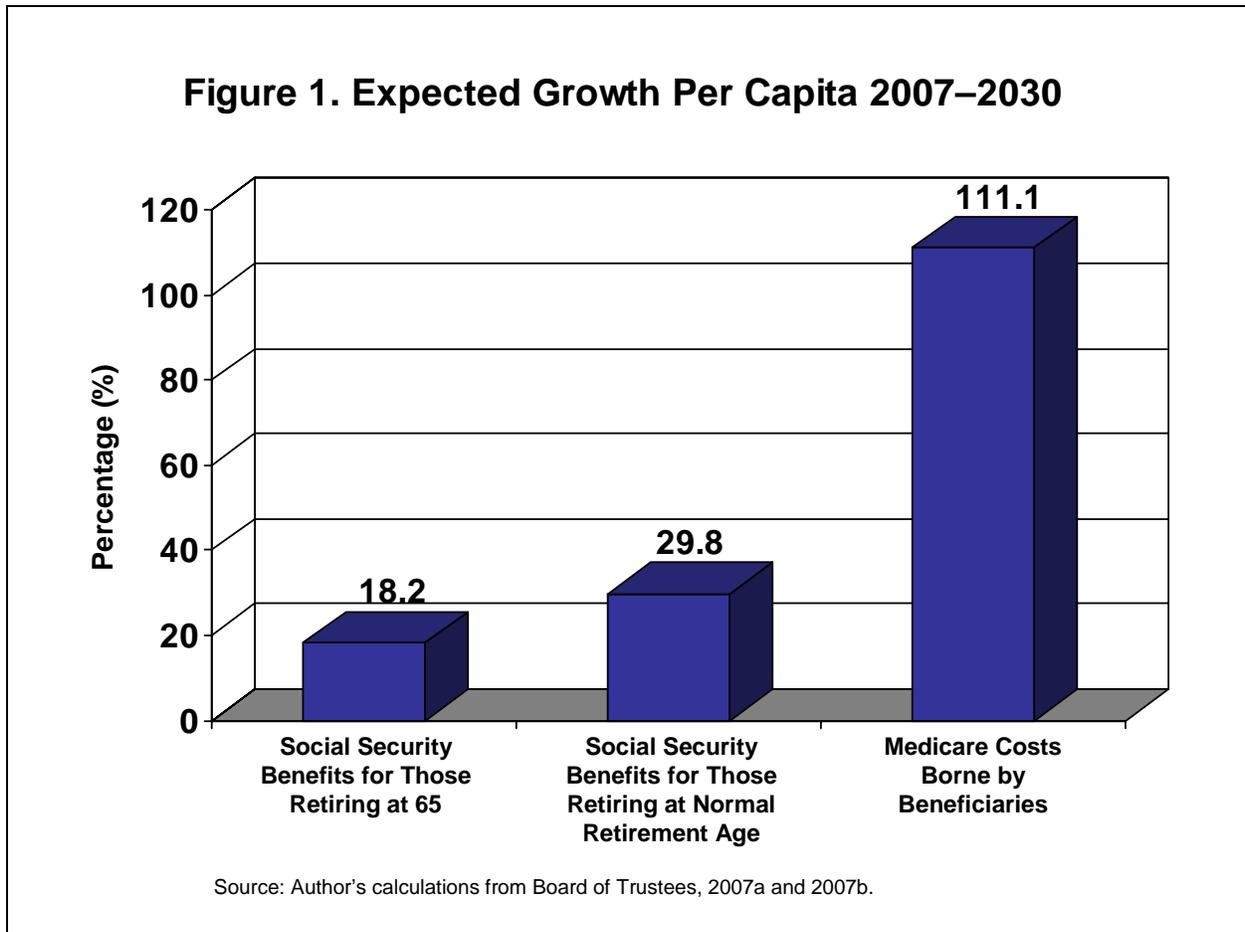
the inequality of incomes that have been observed for nearly four decades (Rubin et al. 2000). And this inequality will extend into the retirement years and might even increase as a result of increases in risk from public programs as well as from private arrangements.

The Challenge of Higher Health Care Costs

The costs of health care already constitute an important burden on the resources of older Americans. Not only are costs of healthcare higher than for younger persons by a factor of over three to one, but the limited generosity of the Medicare program leaves a substantial liability to be picked up by the individual, families, or in some cases employers. This means that individuals over 65 today pay substantially more out of pocket than do younger families. A recent report found that older Americans on average pay more than four times as much as younger Americans for premiums, cost sharing and uncovered health care services (Desmond et al. 2007).

Further, healthcare costs continue to rise at a pace substantially above the incomes of older Americans (Neuman et al. 2007). In contrast to expected income growth, the future burdens of Medicare on retirees are likely to grow rapidly in the future. Medicare beneficiaries pay a substantial share of Medicare's costs including premiums and tax contributions, cost sharing related to Medicare and costs of services that Medicare does not cover. All of these are likely to grow at much the same rate as the overall costs of Medicare. Thus, it is possible to use predictions for the growth in per capita federal payments for Medicare and extrapolate the likely growth in health care burdens that older Americans will experience over time. The data indicate that costs for Medicare related premiums and tax contributions will more than double between 2007 and 2030 (111.1 percent growth). Compare this to the flat or falling income for individuals

as they age, or even to the higher 29.8 percent growth in income that newly retired persons can expect in 2030. Growth in Medicare burdens will be at least three times greater than growth in income (see Figure 1), reducing seniors' ability to purchase other goods and services with the income left after subtracting health care costs.



Changes in the private sector that have reduced pension generosity have had an even more dramatic impact on the availability of retiree health benefits from former employers (and for current workers as well). Each year, fewer employers offer any health coverage once an individual retires. And even for those who do, policy changes, such as reducing the level of the subsidy or lengthening the period of time to qualify for benefits (particularly in retiree health)

have also lowered the benefits that individuals can expect to receive in the future from former employers. This leaves individuals at even greater risk of incurring high out-of-pocket costs for their care over time. Similarly, the decline in employer-covered retiree health insurance leaves more people vulnerable to problems with out-of-pocket health care spending. Again, this is an area where persons with more modest incomes may not work for employers offering such benefits. Over time, retiree benefits are expected to decline substantially, but in the near term, the problems will be more concentrated in the bottom third of the income distribution. Moreover, to the extent those just below the age of 65 lack health insurance, the initial demands on Medicare to “catch up” with needed services will likely rise as well.

Increasing Need for Public Protection

What does this mean for our public programs supporting people in retirement? The need for these programs both to bolster financial status and to protect against risk will increase over time—contrary to claims made by those who hope to see increases in well-being for all seniors. The low income protection programs (Supplemental Security Income and Medicaid) remain limited to the very poor; Social Security and Medicare are critical sources of stability in economic status for those with slightly higher incomes. Even with no change in public policy, the challenges of maintaining standards of living will increase over time. The rising cost of healthcare presents one of the greatest challenges, but increasing the age of normal retirement also constitutes a cut in benefits for those not able to remain longer in the labor force. And the increased risk from other sources of retirement income make a stable base from Social Security and Medicare ever more important.

Three areas of policy changes are important to consider in order to limit damage to the most vulnerable retirees. First, policy changes aimed at a general “fix” for Medicare or Social Security that aim to help the financial situation of the programs can still have a disproportionate impact on those with lower incomes. For example, one change that has garnered considerable attention would reduce the adjustments used in calculating wages that are then used for establishing benefit levels. This would affect lower and higher income beneficiaries alike, but because of greater dependence on Social Security, it will disproportionately hurt those with lower overall incomes. The system needs to become more, not less, progressive over time and there are many options for change that would move in that direction.

A second policy area requiring attention centers on protections put in place for more vulnerable beneficiaries. A good example here is the case of low income protections for Medicare beneficiaries. As healthcare burdens rise as a share of income, extra support from Social Security and/or Medicare would be needed just to sustain an equivalent standard of living net of healthcare as these individuals achieve today. For example, consider the situation of an individual with income at 150% of the federal poverty level—about \$14,000 in income in 2007. Average spending out-of-pocket on health care is likely to be in the range of \$3,000. To retain a constant value of after health-spending income of \$11,000 (in 2007 dollars) would require that income grow twice as fast as Social Security income is expected to rise over time. That is, healthcare will consume an ever larger share of the income of modest income beneficiaries. One policy fix for this issue would be to increase the protection for those with low incomes and raise eligibility the level at which protection ends. Even the most generous protections in Medicare end at 150 percent of poverty at present (for Medicare Part D). To compensate for these higher

healthcare costs, eligibility would need to rise substantially over time—effectively to about 192 percent of poverty just to keep income-after-healthcare-expenses at a constant level over time.

In practice, there is little to indicate any willingness to expand these programs, even for the most vulnerable. Across the board increases will be viewed as unaffordable. And, just as with other programs (like the recent debate over the SCHIP program for low income children), there is little sensitivity to the fact that low income protections likely need to rise over time when health care costs grow as a share of income.

Finally, the third policy area of concern relates to proposals that would increase risk in the public programs. The philosophy behind many current reform proposals for both Social Security and Medicare is to increase personal responsibility—and hence to raise individuals' risks. For the time being, interest in privatizing Social Security has waned, but remains alive and well in proposals for reforming Medicare. Two examples of current policy that already move the program in this direction are the Medicare Advantage private health plan options and the new drug plans under Medicare. In both cases, out-of-pocket liabilities will vary depending upon individuals' choices.

The larger issue, however, is whether future changes (as advocated by some of those policy makers who pushed to expand these private options) will move further toward a defined contribution approach. Rising enrollment in the private plan options increases the feasibility of dismantling the basic traditional program, and relying only on private plans for the provision of care. At that point it also would become easier to make the government contribution a fixed amount each year rather than being linked to a particular benefit package. If so, the subsidies may be capped in such a way that the payments become less adequate to sustain current benefits over time. Higher income individuals could afford to pay higher premiums to sustain their

insurance coverage, but those with lower incomes would likely face the choice of inadequate protection or lower quality care. Again, this represents a shift in risk from government to individuals and is explicitly advocated by those who want beneficiaries to shop for more efficient care over time. Healthcare for vulnerable seniors could thus become more unaffordable over time through explicit policy changes as well as from the expected trend for healthcare costs to continue to rise.

In a period in which the private sector has already shifted considerable risk to retirees, any public reforms to do the same should be viewed with caution. It is not necessary to make such changes in order to hold down costs over time; the issue of the impact on the most vulnerable should be a major aspect of consideration of such reforms.

Thus, a key challenge for the future will be to sustain support both for entitlements overall but also to recognize potentially increasing needs for support for those with lower incomes. But even if changes to hold down the costs of entitlements over time are deemed necessary to these programs, at a minimum, care needs to be taken to avoid weakening protections for the most vulnerable. To truly meet the needs of future low income retirees, some expansion of government programs would be needed.

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