Saving Social Security: A Framework For Reform

The Concord Coalition

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Volume 1: Defining the Problem

KEY PROBLEMS WITH THE SOCIAL SECURITY SYSTEM

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2. There is mounting concern that the current system will either overburden future workers with unsupportable tax hikes or betray future retirees with deep benefit cuts.

3. Under the current system younger workers will receive an increasingly low rate of return on their contributions.

4. Despite a growing consensus that America needs to raise its private savings rate, the current pay-as-you-go benefit structure discourages household thrift.

5. The current system suffers from low and declining public confidence, particularly among young people.

Saving Social Security:
A Framework for Reform

I. THE SOCIAL SECURITY CHALLENGE

Social Security is America's largest and most popular government program. It provides income to 27 million retired people, four million disabled people, and an additional 13 million of their dependents and survivors. One in every four U.S. households includes at least one person receiving Social Security. Over the last half century, Social Security has provided a vital floor of protection. It would be hard to imagine America without it.

Yet the program is unsustainable in its present form.

According to the 1998 Social Security Trustees' report, benefits are on track to exceed dedicated tax revenues by 2013. If that is allowed to happen, the government will have to raise taxes, cut other spending, or borrow from the public to meet its Social Security benefit obligations.

The shortfall will not be an insignificant sum of money. According to the Trustees, if no action is taken, the Social Security deficit will grow steadily. In the year 2030 alone, shortly before the program's trust fund is officially insolvent, Social Security is projected to add $684 billion to the federal deficit. All told, between 2013 and 2032, Social Security will push up the publicly-held national debt by $6.7 trillion—nearly twice the amount the federal government has borrowed since the inauguration of George Washington. By that year, closing Social Security's cash deficit would require a 40% hike in the Social Security payroll tax rate or nearly a 30% cut in benefits.

Action must be taken soon to put Social Security on a fiscally sustainable and generationally equitable basis. The challenge is to reform Social Security in a way that retains its beneficial effects for retired and disabled persons without overburdening workers or the economy.

All Americans, no matter their age, have a stake in the outcome.

Social Security Reform in Context

Social Security does not exist in a vacuum.

Its enormous size—22 percent of all federal spending—means that it has an important influence on the federal budget, and in turn, on the overall economy. Its impact on retirement security for so many older Americans, and its payroll tax impact on working-age Americans, make it an important issue for people of all ages.

Each reform proposal will thus play out in the context of five key areas: demographics, the federal budget, the economy, retirement security, and generational equity.

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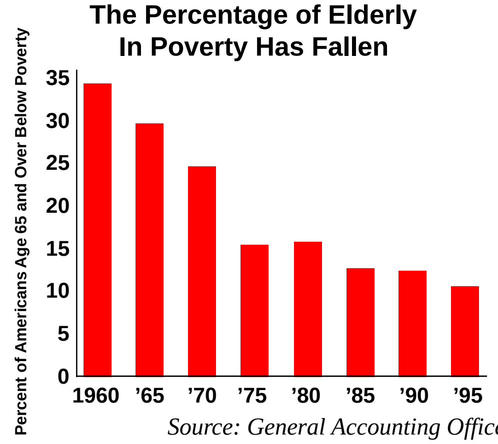
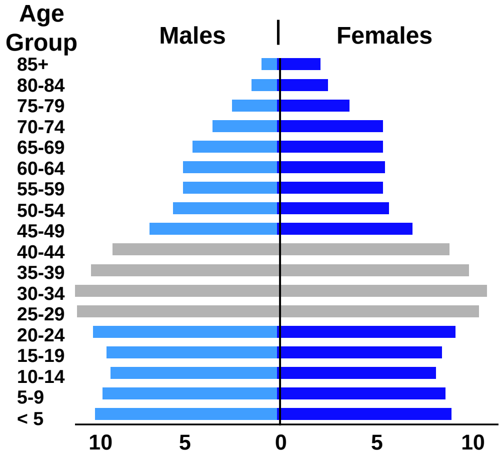
The Percentage of Elderly In Poverty Has Fallen



Source: General Accounting Office

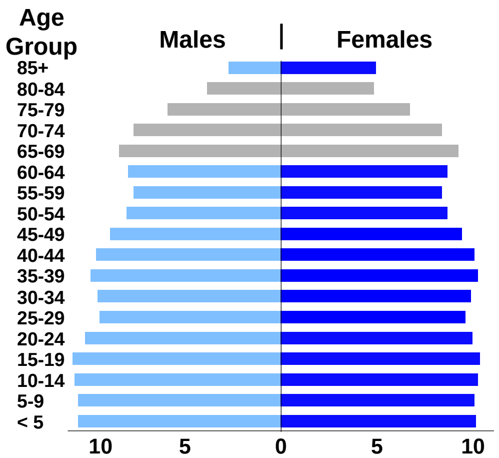
U.S. Population by Age and Sex: 1990



Population in Millions
(Gray Area Indicates baby boomers)

Source: U.S. Census Bureau

U.S. Population by Age and Sex: 2030



Population in Millions
(Gray Area Indicates baby boomers)

Source: U.S. Census Bureau

Demographics is destiny

The driving force behind Social Security reform is something that cannot be avoided—demographics. The United States is an aging nation, and for Social Security, demographics is destiny.

When Social Security was established as a pay-as-you-go program in 1935, no one foresaw the baby boom generation. While it was understood that the program would grow more expensive over time, the birth of 76 million potential beneficiaries between 1946 and 1965 significantly expanded Social Security's long-term obligations and signalled the onset of a permanent aging of the American population.

Further complicating the picture are a welcome but unexpectedly large growth in average life spans and a markedly lower birth rate following the baby boom.

These demographic factors drive the current need to reform Social Security. As Paul Tsongas, a founding co-chair of the Concord Coalition, repeatedly warned, "the numbers are relentless."

According to the U.S. Census Bureau, the number of Americans age 65 and over went from nine million in 1940 to 34 million in 1995, and will reach 70 million by 2032. The number of "old old," those age 85 and over, will grow from four million in 1995 to 19 million in 2050. By that time, *20 percent* of the U.S. population is expected to be age 65 and over—more than the percentage of the people age 65 and over in Florida today.

When Social Security was enacted in 1935, the eligibility age was 65 and the average life expectancy for newborns in the United States was 61. Those who reached age 65 were expected to live another 12 years. Today, the average life expectancy has risen to 76, and the average years of life remaining for those reaching age 65 has risen to 17.4. Despite this, the age for full Social Security benefits has remained at 65, and an "early retirement" option at age 62 has been added to the program.

A gradual increase in the eligibility age for full benefits from age 65 to age 67 is scheduled to take effect between 2003 and 2027. Over the same period, however, life expectancies are projected to rise by two years from 77 to 79, so the average number of years in retirement will remain the same.

But the rapidly rising number of beneficiaries is only one part of the equation. The second part is the declining number of workers paying into the system relative to the number of beneficiaries.

The baby boom was followed by the so-called "baby bust." The inevitable result will be fewer workers supporting each retiree. Between 2010 and 2030, as the number of Americans age 65 and over increases by 72 percent, the number of working-age Americans (20-64) will increase by only four percent. Annual work force growth will decline from the projected rate of 1.0 percent in 1998 to just 0.2 percent between 2010 and 2050.

Social Security was easily affordable when there were five workers for each beneficiary and the payroll tax rate was only six percent, as in 1960. The program is less affordable now when there are three-and-a-half workers for each beneficiary and the payroll tax rate has more than doubled.

The problem will get worse as the full consequences of boom and bust demographics take effect. The ratio of workers per beneficiary will continue to decline, reaching only two-to-one by 2030. A payroll tax of exceeding 17 percent would then be required to maintain current Social Security benefit levels. This, of course, does not include Medicare, the part of the Social Security system that pays for health care for the elderly and disabled. According to the Trustees, the cost of both programs would nearly double as a share of workers' payroll from 16.5 percent today (including both parts of Medicare) to over 30 percent by 2040.

While some argue that it is unduly alarming to dwell on Social Security's projected burden on workers' payroll, the program's pattern of escalating benefits followed by escalating tax hikes demonstrates a legitimate cause for concern.

Social Security's original payroll tax was levied at a two percent rate (employer and employee combined) on the first $3,000 of income. Over the next 60 years, the payroll tax rate and the amount of income subject to the tax (the wage base) have been increased repeatedly. The payroll tax is now levied at a 12.4 percent rate on the first $68,400 of income *(see table on page 11)*.

Fully 70 percent of American workers today pay more in payroll taxes (Social Security and Medicare combined) than in income taxes.

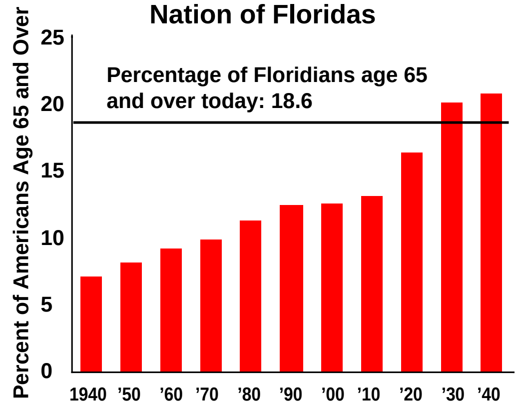
The coming age wave will lead to a permanent aging of the nation. The picture of our changing population is not a python swallowing a pig; it is a python swallowing a telephone pole. The consequences are both long-lasting and unavoidable. There is no going back to reverse either the baby boom or the baby bust. A return to higher birth rates and many families with three, four or five children is very unlikely, and nobody wants shorter life spans. Options for reform of the system can mitigate the effects of demographics, but they cannot change the past.

Budgetary consequences

Social Security is the largest program in the federal budget. In 1998, outlays for Social Security are expected to reach $376 billion—22 percent of all federal spending. By 2008, the year in which the first baby boomers will qualify for early retirement, outlays for Social Security are projected to exceed $600 billion, and its share of all federal spending will reach 25 percent.

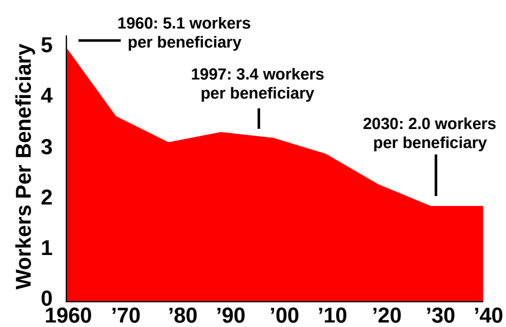
Throughout this ten-year outlook, dedicated tax revenues for Social Security will more than cover its benefit obligations. In fact, due to reforms enacted in 1983, the Social Security system has been running annual cash surpluses since 1984. These surpluses have been credited to

We Are Becoming a Nation of Floridas



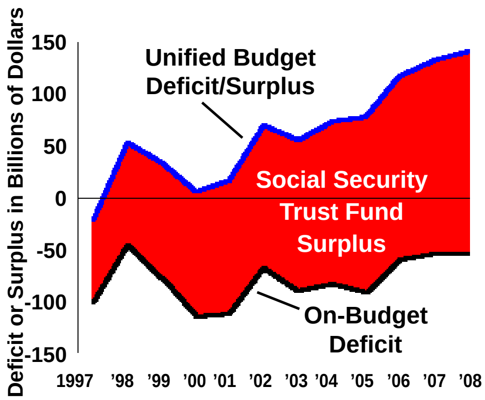
Source: Social Security Trustees

The Worker-Per-Retiree Ratio is Plummeting



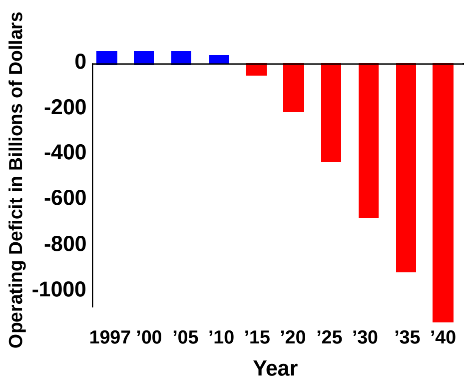
Source: Social Security Trustees

Social Security Surpluses Mask the On-Budget Deficit



Source: Congressional Budget Office and Concord Coalition analysis

Social Security Is Unsustainable in its Present Form



Source: Social Security Trustees

the Social Security trust fund and the money has been loaned back to the Treasury to help defray the costs of other government spending. This practice has allowed the government to borrow less from the public to finance annual deficits than would otherwise have been the case.

Whatever one thinks of this practice, it will come to a crashing halt when the baby boomers begin collecting benefits.

According to the Trustees, Social Security's current cash surplus, now about $50 billion annually, will decline beginning in 2002. By 2013, Social Security will begin running an annual cash deficit. From that point on, absent change, Social Security will represent a large and growing drain on the federal budget.

Social Security's cash deficit will grow from under $20 billion in 2013 to almost $700 billion in 2032, the last year of supposed "solvency." By 2040 the annual Social Security deficit will exceed one trillion dollars. As so many analysts have concluded, this trend is unsustainable.

On paper, interest income and liquidation of principal will allow the Social Security trust fund to show a positive balance through 2032. But the cash needed to make good on these obligations—both interest and principal—will have to come from tax increases, spending cuts, or public borrowing, all of which would constrain the budgetary options of future policy makers.

The key point in this regard is that the "assets" now accumulating in the trust fund represent future general fund liabilities. As such, they cannot ease the burden on tomorrow's workers and taxpayers.

Economic consequences

On its current course, Social Security would have profound implications for the economy—none of them good.

Sustained economic growth would improve future taxpayers' ability to afford the costs of the baby boomers' retirement. If economic growth has slowed to a crawl by 2030, taxpaying workers, retired citizens, and the next generation of youth would be forced to compete for shares of an economic pie that is not large enough to go around. By contrast, a larger economy in 2030, along with higher real wages, would allow for additional breathing room to find the resources to support the huge elderly population while still adequately providing for raising future generations.

But economic growth depends upon savings and investment. Federal budget deficits subtract from national savings and can hinder economic growth. Social Security deficits of the size currently projected for the peak years of the boomers' retirement would put a significant drag on economic growth. By 2030, Social Security's deficits would erase 40 percent of net national savings.

The last major overhaul of Social Security, in 1983, attempted to deal with this problem by running deliberate and growing surpluses within the system. The goal was to increase national savings and spur the economic growth needed to help fund the baby boomers retirement.

So far, the concept has failed because the surpluses have been used to help finance large budget deficits, rather than for debt reduction or productive investment. The net national savings rate has actually declined, leaving us in no better position to finance the boomers' retirement than we were back in 1983.

This history makes it all the more important for present Social Security reform efforts to concentrate on boosting national savings, and with it investment, growth, and a larger economy for the future.

Retirement security[1]

Social Security reform is not simply a green eyeshade issue. It is fundamental to the fabric of the nation's retirement security. The growing dilemma is that even as Social Security's long-term fiscal outlook becomes more problematic, increased numbers of Americans are relying on it to provide most, if not all, of their retirement income. Ninety percent of Americans age 65 and over receive Social Security, and Social Security benefits provide 43 percent of aggregate income for this group.

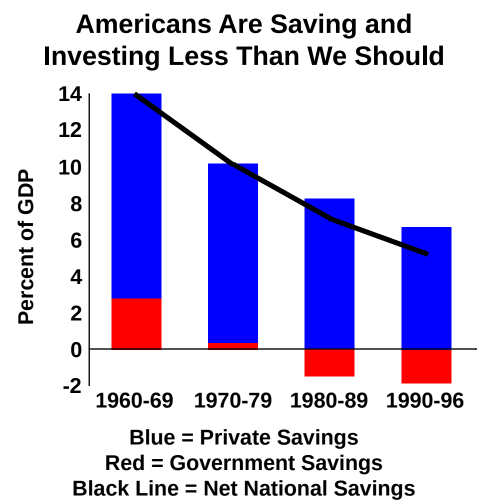
Less than half of the private-sector labor force participates in an employer pension plan, and few people have sufficient savings to ensure an adequate retirement income. Most Americans are simply not prepared for large cuts in Social Security benefits; indeed, most are probably not prepared for the cuts that Congress already legislated in 1983, scheduled to be phased in over the coming decades.

According to a July 1997 study by the General Accounting Office, 54 percent of Americans aged 65 and over would have been below the poverty level in 1994 without their Social Security checks. More striking, however, is that *two-thirds of Social Security beneficiaries get more than half their income from Social Security, and nearly one-third get 90 percent of their total income from Social Security.*

In short, those who can least afford a weakened Social Security system are those most likely to be affected by the failure to enact timely reform. The consequence of inaction—sudden and drastic benefit cuts—would inevitably hurt those at the lowest income levels.

Any consideration of retirement security must also include Medicare. While the problems of Medicare are beyond the scope of this analysis, the two programs are inexorably linked. And, as most analysts conclude, the problems of Medicare are even worse and more immediate.

[1] Disability insurance (DI) is an important part of the overall Social Security system. Although DI's rising cost has triggered much serious debate over cost-savings options, most Social Security reforms treat DI as a separate program whose insurance function and administration are very different from the retirement and survivor portion of Social Security. Accordingly, this analysis focuses primarily on the retirement portion of Social Security.



Source: Department of Commerce data

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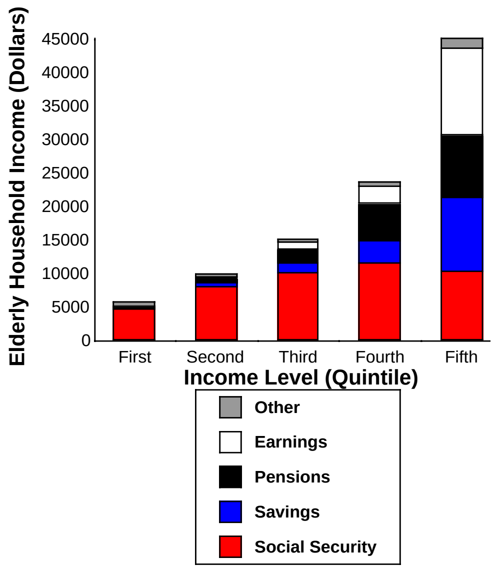
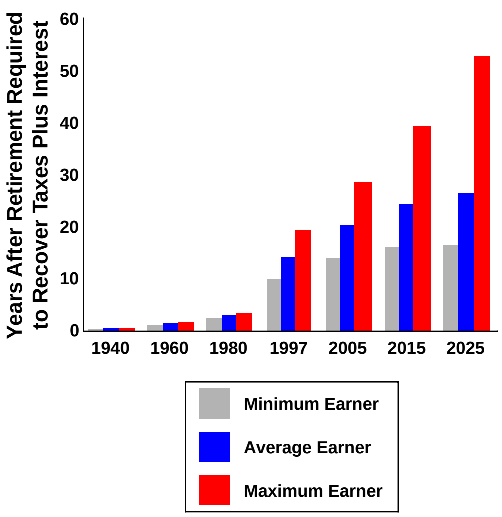
Pensions, Savings, and Earnings Determine Who Will Have the Highest Retirement Incomes



Source: General Accounting Office

It Takes Longer and Longer to Recover Taxes Plus Interest After Retirement



Source: Congressional Research Service

To be clear, the retirement security challenge is not just to find some extra cash for Social Security. The challenge is to prepare for a demographic tidal wave that will transform our work lives, our health care system, our economy, and our culture. Tomorrow's workers might be willing to pay more in taxes if closing the looming gap in Social Security's finances were the only gap they had to close. Unfortunately, it isn't. They will also have to cope with all of the other rising budget costs of an aging America—not just Social Security, but more spending for doctors, hospitals, and nursing homes under Medicare and Medicaid. Total federal spending on just these three programs will hit roughly 40 percent of payroll by 2040.

Generational equity

Traditionally, Social Security has been called the "third rail" of American politics—touch it and you're dead. But increasingly, *failure* to touch Social Security will become a politically dangerous act as the pressure to maintain benefits is rivaled by the pressure to ensure an acceptable rate of return for workers' payroll contributions.

There is growing awareness, and concern, about Social Security's declining rate of return on contributions. Today, for the first time in the history of the program, large categories of newly retiring workers are due to get back less than the market value of their prior contributions, even when that value is computed at the lowest plausible discount rate.

As more Americans become net Social Security "losers," the political pressure for reform will mount. It was easy to say, "don't touch it," when on average everyone was getting back much more than they paid into the system. But in the not-too-distant future few workers will be getting back what they paid into the system. It will be impossible to maintain political support for a public retirement system in which almost everyone loses.

A related development is the change in public attitudes toward government since Social Security was established. When Social Security was originally set up, the "Great Crash" had shattered public faith in financial markets. As a result, people trusted the government more than the market. Today, many Americans under the age of 50 feel just the opposite. Those who lack trust in the government are more inclined to want ownership and control over their savings rather than to rely on promises of a future Social Security check.

Many workers are also noticing how Social Security's benefit and tax patterns have changed since the program's inception. For 40 years, the pattern had been for Congress to frequently expand benefits and, almost as frequently, increase the tax burden to keep the system solvent. In 1977, this scenario changed. Since 1977, changes have essentially raised the tax burden while simultaneously restraining benefits. In essence, the program has gone from tax and spend to tax and cut. The bottom line is not reassuring to workers of any age.

When considering Social Security reform options, policy makers need not, and should not, choose sides between young and old. That is a false choice. What is important is that all Americans, regardless of age, be convinced that Social Security reform is in their best interest.

The Reform Challenge

Despite the growing awareness of Social Security's long-term problems, enacting reform will not be an easy proposition. There are two basic dilemmas. First, the full consequences of the problems now apparent in the system will not hit for several years, and while there is still time to avoid a crisis, doing so requires that action be taken soon even though on the surface all seems well.

The second basic dilemma of Social Security reform is that none of the realistic options for addressing the program's structural problems comes without a fiscal or political price. When looked at carefully, each proposal involves trade-offs. The most credible reform plans will be those that candidly deal with the trade-offs and explain why a particular approach was chosen over another.

Defining the Problem

Social Security's problems can be fixed. The question is how to do it. Raise taxes? Reduce benefits? Invest the operating surpluses in the stock market? Transition to a two-pillar system featuring private accounts? Fully privatize? All of these ideas will receive attention, in one form or another, during the coming debate over Social Security reform.

There is no perfect reform plan. The political process is one of debate and compromise. In the end, no one is likely to get his or her ideal result. But the process of reform must begin with a definition of the problems facing the current system and a set of criteria for judging how each reform proposal addresses those problems.

KEY PROBLEMS WITH THE SYSTEM

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2. There is mounting concern that the current system will either overburden future workers with unsupportable tax hikes or betray future retirees with deep benefit cuts.

3. Under the current system younger workers will receive an increasingly low rate of return on their contributions.

4. Despite a growing consensus that America needs to raise its private savings rate, the current pay-as-you-go benefit structure discourages household thrift.

5. The current system suffers from low and declining public confidence, particularly among young people.

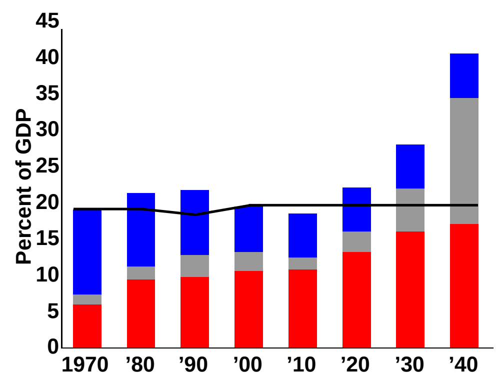
THE REFORM CHALLENGE

Attempting to close the gap between dedicated tax revenues and projected benefits by incurring the massive new public debt required would consume the savings needed to spur economic growth, leading to a destructive spiral of higher interest costs and slower growth that would hurt the living standards of all Americans.

Attempts to close the fiscal gap by simply raising taxes on workers or lowering benefits for retirees would inevitably result in a less generous program paid for at an increasingly burdensome cost—a generational lose-lose proposition.

Transitioning out of the current pay-as-you-go system into a funded or partially-funded system of privately owned accounts inevitably requires some group of workers to pay for the prefunding of the new system while at the same time maintaining funding for those still receiving or expecting to receive benefits under the old system.

When the Boomers Retire, Entitlements and Interest Will Exceed Revenues



(Red indicates entitlement spending, gray indicates net interest, blue indicates discretionary spending. The black line is total revenues.)

Source: Congressional Budget Office and Concord Coalition analysis

II. REFORM CRITERIA

Several members of Congress and independent organizations have already come forward with reform plans. How should the public evaluate these plans? The Concord Coalition suggests the following criteria:

1. Social Security reform should ensure a reasonable standard of living for older Americans, protecting them against poverty and loss of income.

As a threshold matter, reform of the current Social Security system should ensure that its vital safety net is, at a minimum, maintained—and ideally, improved. While employment pensions and personal savings are crucial to retirement security, Social Security can, and should, provide a broad and solid retirement income supplement to these other sources of retirement income.

A reasonable standard of living means more than keeping out of poverty; it means ability to maintain a standard of living in retirement that is not drastically lower than that enjoyed during working years.

Reform must protect lifetime low earners by preserving the progressive benefit element of the current system. Protection against old-age poverty has been greatly increased through the current system. This protection should be maintained—or, indeed, improved. A reasonable goal would be to guarantee every beneficiary an income equal to 100 percent of the poverty floor—something the current system does not do, even in conjunction with Supplemental Security Income (SSI), the means-tested cash-benefit program for the elderly and disabled.

Finally, reform must also continue the current system's protection against loss of income due to death of a spouse or due to outliving one's resources.

2. Reform should ensure that annual outlays under the pay-as-you-go Social Security program do not exceed annual tax revenues.

The most commonly used measurement of Social Security's solvency is its 75-year "actuarial balance," which according to the 1998 Trustees report is minus 2.2 percent of payroll. In theory, this is the total amount by which Congress would have to raise taxes or cut benefits, starting today, to keep the Social Security trust fund solvent over the next 75 years.

In the framework of actuarial balance, Social Security will be solvent until the year 2032—meaning that until then, its trust funds are projected to possess sufficient assets to cover current law benefit promises. According to this thinking, if Congress were to enact changes to close the 2.2 percent actuarial deficit, the trust funds would be solvent for the next 75 years.

CONCORD COALITION CRITERIA FOR SOCIAL SECURITY REFORM

1. *Social Security reform should ensure a reasonable standard of living for older Americans, protecting them against poverty and loss of income.*
2. *Reform should ensure that annual outlays under the pay-as-you-go Social Security program do not exceed annual tax revenues.*
3. *The Social Security system should not add significantly to the publicly-held debt.*
4. *Social Security reform should contribute to an increase in net national savings.*
5. *Social Security reform should reflect generational equity by improving the rate of return on contributions for future workers.*
6. *The burden of Social Security reform should be borne fairly by age and income groups.*
7. *Public confidence in the Social Security system should be bolstered by ensuring adequate protection against both political and investment risks.*
8. *Prudent assumptions should be used to evaluate all reforms.*

The problem with this measure of solvency is that it is an accounting fiction. Actuarial balance assumes that trust fund surpluses accumulated in prior years constitute genuine economic savings that can be drawn down to cover trust fund deficits incurred in future years. They don't. Since the assets held by Social Security consist of Treasury securities, when it is time for the trust funds to redeem them, Congress must raise taxes, cut other spending, or borrow more from the public to raise the cash.

Fiscally, what really matters is Social Security's operating balance—that is the annual difference between its outlays and its dedicated tax revenues. In the end, trust fund accounting sidesteps the real issue, which is not how to meet some official solvency test, but how to ensure Social Security's fiscal sustainability and generational fairness.

Social Security reform plans should begin by recognizing that the 75-year actuarial balance measurement, and its 2.2 percent solution, mislead the public about the magnitude of the future fiscal burden posed by Social Security, and say nothing about the program's impact on national savings or generational equity. A better measurement of Social Security's solvency is its projected operating balance. In other words, reforms should lead to a very high likelihood that we will be truly able to "pay-as-we-go."

3. The Social Security system should not add significantly to the publicly-held debt.

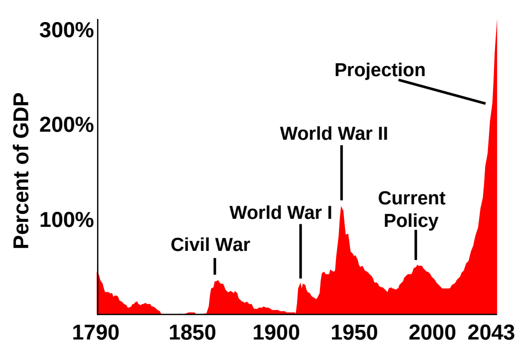
On its current course, Social Security will add trillions of dollars to the publicly-held debt between 2013, the year the system begins to run a cash deficit, and 2032, the last year of official trust fund solvency. Beyond that, the debt will only continue to grow.

Because the aging of America is a permanent phenomenon, it will not be possible to borrow our way through it. Attempting to do so would consume the savings needed to spur economic growth, leading to a destructive spiral of higher interest costs and slower growth that would hurt the living standards of all Americans.

Avoiding the adverse economic consequences caused by cascading public debt is a challenge for ***all*** reform plans, whether directed at the current pay-as-you-go system or at transitioning to a prefunded system.

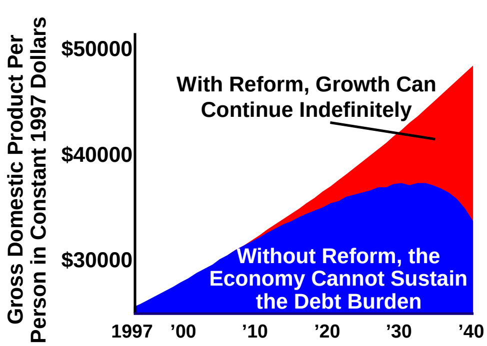
A number of plans have been put forth for creating a mandatory program of prefunded private retirement savings accounts either to complement or to replace current Social Security benefits. Establishing such a system to prefund retirement benefits for today's workers while also continuing to provide benefits to today's retirees under the current pay-as-you-go program poses a transition challenge. Today's young workers would have to put aside enough in their new private savings accounts to provide adequate retirement benefits for themselves, while continuing to pay taxes to finance retirement benefits for their parents and grandparents.

If We Borrow to Pay Future Entitlement Benefits, the National Debt Will Grow to an Unsustainable Size



Source: Congressional Budget Office and Concord Coalition analysis

Entitlement Reform: A Choice Between a Stagnant Economy or Continued Growth



Source: Congressional Budget Office, Concord Coalition analysis

Issuing substantial new public debt to finance the transition to a new system requiring partial or complete reliance on private savings may appear, at first, to be a painless option. After all, proponents say, the current system already promises $8 trillion more in benefits than it has the dedicated tax revenue to pay for. Making some or all of those implicit liabilities explicit by issuing "recognition bonds" does not change anything in reality.

But this misses the point. It is precisely because future taxpayers may be unable or unwilling to make good on an $8 trillion debt in the future that the issue of Social Security reform is being forced to the front burner now rather than a decade or two in the future.

Prefunding retirement benefits, by definition, means that we must begin to save at a higher rate and, therefore, consume at a lower rate—at least until the productivity advantages of higher savings are felt. Otherwise, no additional economic resources will have been dedicated to building retirement security and neither workers nor retirees will be better off.

What matters is real economic resources rather than paper I.O.U's. Social Security should involve as little debt financing as possible. The economic pie at any given time is only so large. The same dollars cannot simultaneously be put aside for future benefits for today's workers and used to pay benefits to today's retirees. It is obvious that raising taxes or cutting benefits is politically difficult. Filling the gap with new debt may be easier politically, especially if the debt is not clearly visible, but this only postpones the day when taxpayers must somehow find the real resources to pay benefits to retirees.

4. Social Security reform should contribute to an increase in net national savings.

The economy in the future will be called on to transfer real resources to retirees, and these resources will be much easier to find in a wealthier, growing economy than in a pinch-penny stagnant one. Unless wages, adjusted for inflation, grow substantially, the burden of paying for Social Security and Medicare could reduce the net wages of tomorrow's working age citizens below today's after-tax levels.

The best way to achieve economic growth and increase real income in the future is to increase savings today. Savings provide the capital to finance investments that will increase the amount of goods or services each worker can produce. Investments in research and development, education, training, plants, equipment, technology, communications, and transportation all can help increase productivity. It is these productivity increases that lead to higher real wages and greater wealth.

Unfortunately, the savings rate in the United States has declined in recent decades, and is now lower in comparison to most other nations. We have been lucky to be able to make up for this by attracting savings from abroad, but that might not last. Many nations must cope with age waves even greater than our own. We should not expect that they will have spare capital to send our way to finance U.S. economic expansion.

What we do about Social Security can lead to greater national savings. Or it can dampen savings—directly, through huge future deficits, and indirectly, by leading people to expect that government benefits will replace money they otherwise would have saved for retirement.

5. Social Security reform should reflect generational equity by improving the rate of return on contributions for future workers.

According to most experts, a growing share of new retirees are not getting back the market value of what they paid into the system and the vast majority of tomorrow's retirees will find themselves deep in the red.

Social Security does and should provide a relatively better deal to some categories of workers, especially low-earners. But among today's younger Americans, virtually all categories—including the favored categories—will do worse than the market.

The basic problem lies in Social Security's pay-as-you-go structure. This structure allowed early cohorts of beneficiaries, rich and poor alike, to receive windfall paybacks far in excess of the market value of their lifetime contributions. But there was a tradeoff: the decision not to establish a funded system inevitably meant that later cohorts of beneficiaries would suffer market losses.

That has already begun to happen and, without change, will become more pronounced over time. Reforms that merely raise taxes or cut future benefits will only worsen this escalating pattern of generational inequity.

Social Security, of course, is not simply an investment program. It also provides insurance protection to widows, survivors, and the disabled. But its declining rate of return on workers' contributions jeopardizes public support for the system and imposes an increasingly unfair burden on future generations. Thus, any reforms ought to result in an improved return than what is currently in store for today's young workers.

6. The burden of Social Security reform should be borne fairly by age and income groups.

The pay-as-you-go financing of the current system shifts the costs of benefits for today's retired generations to current and future generations of workers. Current and past retirees have benefitted from a massive intergenerational transfer, but under the present system, current and future generations of workers will receive far smaller net benefits.

Although we should try to improve the deal for coming generations, it is unrealistic to try to achieve equitable treatment of different generations by "leveling up:" guaranteeing future generations the same gener-

The FICA Tax Rate Has Grown Larger Over Time

Calendar Year	Contribution Base	Contribution Rates %: OASDI*	Contribution Rates %: Self-employed OASDI
1937-49	$3,000	1.000	—
1950	3,000	1.500	—
1951-53	3,600	1.500	2.250
1954	3,600	2.000	3.000
1955-56	4,200	2.000	3.000
1957-58	4,200	2.250	3.375
1959	4,800	2.500	3.750
1960-61	4,800	3.000	4.500
1962	4,800	3.125	4.700
1963-65	4,800	3.625	5.400
1966	6,600	3.850	5.800
1967	6,600	3.900	5.900
1968	7,800	3.800	5.800
1969	7,800	4.200	6.300
1970	7,800	4.200	6.300
1971	7,800	4.600	6.900
1972	9,000	4.600	6.900
1973	10,800	4.850	7.000
1974	13,200	4.950	7.000
1975	14,100	4.950	7.000
1976	15,300	4.950	7.000
1977	16,500	4.950	7.000
1978	17,700	5.050	7.100
1979	22,900	5.080	7.050
1980	25,900	5.080	7.050
1981	29,700	5.350	8.000
1982	32,400	5.400	8.050
1983	35,700	5.400	8.050
1984	37,800	5.700	11.400
1985	39,600	5.700	11.400
1986	42,000	5.700	11.400
1987	43,800	5.700	11.400
1988	45,000	6.060	12.120
1989	48,000	6.060	12.120
1990	51,300	6.200	12.400
1991	53,400	6.200	12.400
1992	55,500	6.200	12.400
1993	57,600	6.200	12.400
1994	60,600	6.200	12.400
1995	61,200	6.200	12.400
1996	62,700	6.200	12.400
1997	65,400	6.200	12.400
1998	68,400	6.200	12.400

*** - this rate is paid by both the employer and employee**

Source: Social Security Trustees

ous and growing intergenerational transfer today's retirees enjoy. In the future, there simply will not be enough working-age Americans to finance them. At the same time, however, today's youth should not be expected to bear the entire burden of making needed reforms.

The benefits and costs of any reform should be distributed fairly and equitably among Americans of *all* ages and income groups. Only the very poor should be exempt from the sacrifices required to solve Social Security's long-term challenges. People with adequate resources who are in their 60's and older today should not be considered automatically exempt from sharing in the transition to a sustainable system simply on the basis of their age.

Annual Long-Term Rates of Return of Different Types of Investments

	Large Company Stocks	Small Company Stocks	Long-Term Corporate Bonds
1930-70	8.7	12.5	3.4
1940-80	10.9	16.6	2.7
1950-90	12.1	13.9	5.4
1960-96	11.1	14.5	7.4

(in percent)

Source: Ibbotson Associates, Stocks, Bonds, Bills, and Inflation 1997 Yearbook, Tables C-1, C-2, and C-3.

7. Public confidence in the Social Security system should be bolstered by ensuring adequate protection against both political and investment risks.

Many young people do not expect that Social Security will provide them adequate, or indeed any, benefits. And many middle-aged people wonder whether they can rely on Social Security, along with their workplace pensions and their own savings, to provide a secure retirement.

A reformed system should give people a sense of confidence that, after a lifetime of work, they will have an adequate retirement income. Further, they should have confidence that the institutions that administer and manage their retirement benefits will not be captive to political pressures in the future.

This means that any Social Security reform must ensure adequate protection against both the political risk that future Congresses might lower benefits and the investment risk inherent in any system of personally-owned accounts.

It is important not only that any reforms are effective but that people are able to understand the general outlines well enough to have confidence in the reformed system. A downfall of the Clinton administration's proposed national health reform was its incomprehensibility to even the well-informed; in the end it proved impossible to explain the plan in terms that the public could grasp.

8. Prudent assumptions should be used to evaluate all reforms.

Before deciding whether to adopt any particular reform plan it will be essential to look closely at the numbers—particularly the demographic and economic assumptions. Almost any plan can appear workable if its assumptions are drawn to fit the conclusion.

Among the most important assumptions to examine are those relating to productivity growth, growth in life expectancy, labor force participation, real rates of return on privately-owned accounts, administrative costs, and the effects of any reform on national savings.

III. FRAMEWORK FOR REFORM

Preparing Social Security to meet the challenges ahead when the baby boom generation reaches retirement will involve many changes to the existing system. No single combination of policy options is the "right" or "best" one. Each involves trade-offs and affects different age groups and populations in different ways.

Early Action Favors the Best Outcome

Because most of the options for reform involve difficult choices, there is a temptation to continue the debate indefinitely over what to do; however that is a luxury we can ill afford. Early action should be taken for a number of reasons:

- The window of opportunity created by current favorable demographics will slam shut in the next decade. Instead of having a relatively small population aged 65 and older and a disproportionately large number of baby boomers in the work force, the boomers will move into the ranks of the retired, while those replacing them in the work force will be fewer in number. *(see chart on page 2)*

- The window of opportunity created by the economic performance in the current business cycle may not continue. The current expansion is the third longest in our nation's history and, if it endures through January 2000, would set an all-time record. However, we ought not expect low unemployment, low inflation, and robust growth to continue indefinitely.

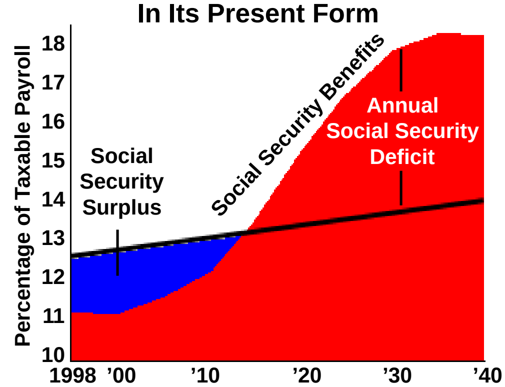
- Phasing in reforms gradually requires the lead time provided by early action. Reforms that are rapidly instituted create "notches"—abrupt changes from one year to the next that highlight different treatment of different age groups.

- People will need to adjust their own retirement security plans and savings behavior in response to changes in the Social Security program. The sooner they find out what the changes are, the sooner they can take the steps required to have an adequate retirement income. This is particularly important for middle-aged workers with only a decade or two to go before retirement, especially if reforms are enacted that require greater reliance on private savings.

Options for Reform

Reform options range from tinkering with the current pay-as-you-go Social Security program in order to finance future benefits to entirely replacing it with a new prefunded program based on privately-owned savings. In reality, neither course is likely to be adopted. Reform is far more likely to involve a mix of both concepts: adding some element of private market investments and making incremental adjustments to scale back the current program to a level that will be sustainable during and after the boomers' retirement.

Social Security Is Unsustainable In Its Present Form



Black Line = Social Security Payroll Tax Plus Income Tax on Social Security Benefits

Source: Social Security Trustees

Defined Benefit

The current Social Security program, like many traditional employer-provided pensions, is a "defined benefit" program. That is, it promises workers in advance that their contributions will make them eligible for future benefits according to a fixed-dollar formula based on their lifetime earnings record.

One approach to reforming Social Security would be to continue to rely exclusively on a defined-benefit approach and make the changes necessary to shore up the existing program. A number of incremental changes to the existing system, such as payroll tax rate increases, reductions in cost of living adjustments, gradually increasing the retirement age, means testing benefits, or changing the formula for determining initial benefits could be gradually implemented to close the financing shortfall.

While it is possible to enact such a package of reforms, it would be extremely difficult to do so in a way that satisfied all of the reform principles discussed in section two of this analysis. Increasing payroll taxes would provide an even worse rate of return on contributions than the below-par returns provided under the current system. Alternatively, across-the-board benefit reductions would risk putting some older Americans into poverty and could fail to assure a reasonable standard of living.

The only way to maintain the current program and also escape this dilemma would be to deficit finance the program when annual balances turn negative, but this would make the program's generational inequities even greater than they are today. Making the current system solvent may not result in increased ***private*** savings, but the ***government's*** currently projected dissaving due to program imbalances would be eliminated if a way could be found to make the program's income and costs balance over the long haul.

Defined Contribution

In contrast to the defined-benefit model, some reform proposals would move the program partially or entirely toward a "defined contribution" approach, more like the 401(k) plans that have soared in popularity in the workplace. Defined contribution plans simply give workers the market return on their contributions, less any administrative costs. As such, they are inherently prefunded.

Defined contribution options involve creating a program of personally-owned retirement savings. These savings could either replace the current defined-benefit program, be added onto the current program, or be combined with a scaled-back defined-benefit program to create a two-pillar Social Security system. Defined contributions could be made mandatory, or provided as an option for workers to choose to supplement or replace Social Security benefits.

The challenge of moving to a complete or partial defined contribution system is that, until the transition is complete, workers will have to pay for ***two*** retirements: their own, which would have to be prefunded, and that of current retirees, who will continue to rely on pay-as-you-go benefits. Workers will thus have to save more, retirees will have to receive less, or both. Reform plans that pretend otherwise are engaging in false advertising.

The rationale for paying the transition cost of a prefunded defined contribution, or two-pillar, system is that when fully phased in, it would solve the long-term fiscal problem of today's pay-as-you-go system, increase national savings, offer workers the security of personal accounts, and eliminate some of the needless penalties and subsidies of the current system associated with marital status and age of retirement. When fully phased in, it almost certainly would provide a better rate of return on contributions made by future workers while ensuring a reasonable or higher standard of living for retirees.

REFORM OPTIONS

These options are explained and discussed in an accompanying booklet: Saving Social Security: Options for Reform.

DEFINED BENEFIT REFORM OPTIONS

Some of the options for reforming the current defined-benefit system include:

- raising the Social Security retirement age,
- making an explicit reduction of initial benefits,
- reducing cost of living increases,
- means-testing benefits,
- raising the wage base and tax rates,
- investing the Social Security trust fund assets in private markets, and
- including all new state and local employees in Social Security.

DEFINED CONTRIBUTION REFORM OPTIONS

More than a dozen proposals have been put forth to create a defined-contribution program of mandatory personal savings to supplement or replace Social Security retirement benefits. These include:

- Options II and III of the recent Social Security Advisory Council Report: the *Gramlich* plan and the *Schieber-Weaver* plan.
- Several plans advocated by members of Congress: the *Gregg* plan (Sen. Judd Gregg, R-NH); the *Kasich* plan (Rep. John Kasich, R-OH); the *Kerrey* plan (Sen. Robert Kerrey, D-NE); the *Moynihan* plan (Sen. Daniel Patrick Moynihan, D-NY); the *Porter* plan developed in consultation with Peter Ferrara (Rep. John Porter, R-IL, Peter Ferrara of the CATO Institute); the *Roth* plan (Sen. William V. Roth Jr., R-DE), the *Sanford* plan (Rep. Mark Sanford, R-SC); and the *Smith* plan (Rep. Nick Smith, R-MI).
- Several plans sponsored by educational foundations: the *CSIS* plan (Center for Strategic and International Studies); the *ES 2000* plan (Sam Beard, Economic Security 2000); the *CED* plan (Committee for Economic Development); and the *NTP* plan (National Thrift Plan of the National Taxpayers Union Foundation);
- Several plans developed by academic economists and financial experts: the *Feldstein* plan (Martin Feldstein, Harvard University); the *Kotlikoff-Sachs* plan (Lawrence Kotlikoff, Boston University and Jeffrey Sachs, Harvard University); the *Altig-Gokhale* plan (David Altig and Jagadeesh Gokhale, Cleveland Federal Reserve); and the *Carter-Shipman* plan (Marshall Carter and William Shipman, State Street Bank and Trust Company.)

Although the plans vary in their specific details, and each has unique features, they nevertheless fall into two patterns based on their architecture once they are fully implemented:

- Full "Privatization" plans: defined-contribution mandatory private savings would gradually replace the entire current defined-benefit program. Examples of this approach are the Altig-Gokhale, Carter-Shipman, Kotlikoff-Sachs, NTP, and Sanford plans.
- "Two-pillar" plans: retirees would rely on benefits financed through both defined contributions and a scaled-back Social Security program. "Carve-out" plans would finance personal savings accounts by diverting some of the current payroll tax into private retirement accounts. "Add-on" plans would require payments in addition to the current payroll tax in order to finance private retirement savings. Both types of two-pillar schemes would gradually scale back the current defined-benefit program to put promised benefits and sources of financing into balance. "Carve out" plans include the CSIS, ES 2000, Feldstein, Gregg, Kerrey, Moynihan, Porter, and Schieber-Weaver plans. "Add on" plans include the Gramlich, Kasich, Roth, and CED proposals.

SOCIAL SECURITY FACTS AND STATISTICS

Financial Status of Social Security

($ in billions, 1998 intermediate projection of Social Security Trustees)

Year	Income (Excluding Interest)	Outgo	Surplus/Deficit
1998	$435	$383	$52
1999	450	396	54
2000	468	413	54
2005	585	533	52
2010	756	724	32
2015	965	1,014	-49
2020	1,217	1,430	-214
2025	1,525	1,958	-433
2030	1,917	2,601	-684
2035	2,418	3,342	-925
2040	3,043	4,190	-1,147

Recipients *(as of July 1997)*

Total	43.8 million	100.0%
Old-Age and Survivors Insurance	37.7 million	86.1%
Disability Insurance	6.1 million	13.9%
Entitled on their own work records	31.5 million	71.9%
Entitled as dependents	12.3 million	28.1%
Widows(ers) and surviving parents	*(5.4 million)*	*(12.3%)*
Wives/husbands	*(3.2 million)*	*(7.2%)*
Children	*(3.7 million)*	*(8.5%)*
(as of June 1997)		
Age 65 or older	31.7 million	72.4%
Under age 65	12.1 million	27.6%

Taxpayers in 1998 *(January 1998 Social Security Administration estimates)*

Number of wage and salaried taxpayers*	140.1 million
Number of self-employed taxpayers	13.7 million
Total taxpayers**	148.2 million

** - Includes self-employed people who work as wage or salaried employees.*
*** - Includes taxpayers who pay both FICA and SECA taxes. An additional 3.5 million people pay only the hospital insurance (HI) portion of the tax.*

Social Security Tax Rates

FICA rate is paid by employee and employer:	7.65% each
SECA rate is paid by self-employed:	15.30%*

** - The self-employed now compute the tax using only 92.35% of net earnings, and one-half of the tax so computed is deductible for income tax purposes.*

How the Tax Rates Are Divided

	FICA rate (employee/employer each)	SECA rate (self-employed)
Old-age, survivors, and disability insurance (OASDI)	6.20%	12.4%
Hospital Insurance (HI)	1.45%	2.9%
Total (OASDI and HI)	7.65%	15.3%

The upper limit on the OASDI tax in 1998 is $68,400. There is no limit on the HI tax. In 1994, 94.6% of workers had earnings below the OASDI maximum.

THE CONCORD COALITION

The Concord Coalition is a nonpartisan, grassroots organization dedicated to eliminating federal budget deficits and ensuring Social Security, Medicare, and Medicaid are secure for all generations. The Concord Coalition was founded in 1992 by the late former Senator Paul Tsongas (D-Mass.), former Senator Warren Rudman (R-N.H.), and former U.S. Secretary of Commerce Peter Peterson. Former Senator Sam Nunn (D-Ga.) was named the new co-chair of The Concord Coalition in April 1997.

Co-Chairmen

Hon. Warren Rudman
Former United States Senator
(R-N.H.)

Hon. Sam Nunn
Former United States Senator
(D-Ga.)

❑ YES! I want to join The Concord Coalition. I want equitable and responsible fiscal policy as we enter the 21st Century. Enclosed is my contribution in the amount of:

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❑ YES! I want to get involved with Concord Coalition volunteer activities. Please have a local representative contact me.

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CONCORD COALITION CRITERIA FOR SOCIAL SECURITY REFORM

1. *Social Security reform should ensure a reasonable standard of living for older Americans, protecting them against poverty and loss of income.*

2. *Reform should ensure that annual outlays under the pay-as-you-go Social Security program do not exceed annual tax revenues.*

3. *The Social Security system should not add significantly to the publicly-held debt.*

4. *Social Security reform should contribute to an increase in net national savings.*

5. *Social Security reform should reflect generational equity by improving the rate of return on contributions for future workers.*

6. *The burden of Social Security reform should be borne fairly by age and income groups.*

7. *Public confidence in the Social Security system should be bolstered by ensuring adequate protection against both political and investment risks.*

8. *Prudent assumptions should be used to evaluate all reforms.*