Saving Social Security: A Framework For Reform

The Concord Coalition

July 1998

Volume 2: Options for Reform

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.

Saving Social Security: Options for Reform

I. DEACTIVATING THE "THIRD RAIL"

Social Security is no longer the "third rail of American politics"—touch it and you die. Reform plans are springing up from congressional sponsors of both parties in the House and Senate. Several Social Security reform bills have been introduced in the 1997-98 session of Congress alone, and legislative action is promised for 1999.

Scholars, think tanks, and interest groups are joining in with reform plans. The media are beginning to discuss the issue. Public opinion polls increasingly show that the American people are concerned about Social Security's future, and are hungry for information about how the program can be saved.

In short, a national dialogue on the future of Social Security has begun, and every American has a stake in the outcome.

It is clear, however, that despite growing public awareness of the need for Social Security reform, no consensus has developed on the best way to do it. As one would expect in a nation as diverse as ours, ideas for reforming Social Security span the political spectrum. Proposals range from modest adjustments within the current system to major restructuring of the program.

Of course, reform would be easy if there were some way to fund currently projected benefits without raising taxes or incurring massive federal debt. But there is no such "magic bullet," and reform efforts should not be delayed in hope of finding one.

In assessing the options for reform, it is important to begin with the understanding that no option comes without a fiscal or political price. Each involves trade-offs and affects different people in different ways. That is why it is so important to assess each reform option in light of its positive aspects as well as its trade-offs. Sacrifice will be required because regardless of the trade-offs one thing is certain: **doing nothing is the worst option.**

Why reform is important: the problems of pay-as-you-go financing

The driving force behind reform is the combination of Social Security's pay-as-you-go financing structure and the nation's changing demographics. In a pay-as-you-go system, workers do not prefund their own retirement benefits. Instead, the money that is deducted from each paycheck is used to pay the benefits of current retirees.

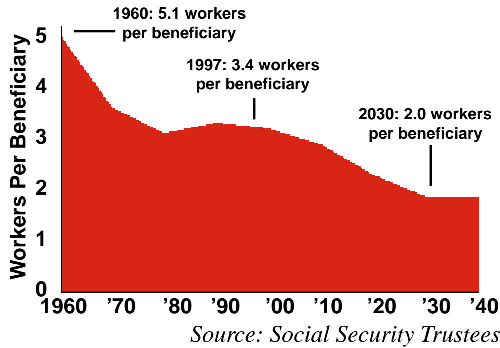
The system works well when there are many workers and relatively few retirees, when wage growth is strong and the country is growing. In such circumstances, the tax burden on each worker is not very great and, on average, retirees receive an excellent return on their contributions provided they live long enough to collect benefits.

"There are a range of reasonable solutions to the problem that are going to be somewhat painful. There are some choices that people will have to make—but this is not a revolution necessarily. If people decide they want more dramatic change, that's one thing. We do not have to take that as the only solution to the program."

— Marilyn Moon,
Public Trustee of the Social Security and Medicare Trust Funds
"The Great Social Security Debate," Cranston, R.I., July 1, 1998.

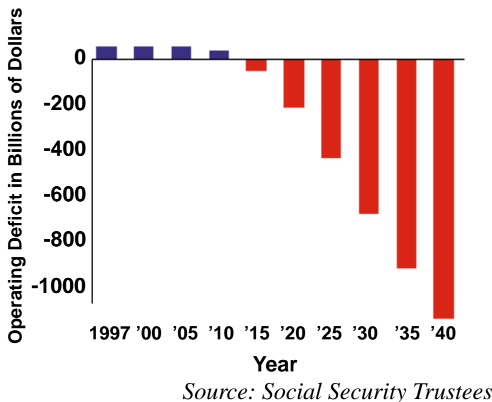
"Realistically today, I think many people believe—if not most—that simply raising taxes and keeping the current system is not politically feasible. Therefore, we need to look at more comprehensive reforms that are balanced to make the program certain, secure, sustainable, improve the rates of return, and yet still have that foundation of security."

— David Walker,
Former Public Trustee of the Social Security and Medicare Trust Funds
"The Great Social Security Debate," Kansas City, Mo., April 7, 1998.



Source: Social Security Trustees

Note 1: Source: "Social Security: The Relationship of Taxes and Benefits for Past, Present and Future Retirees," Congressional Research Service Report 95-149, updated May 12, 1998.



Source: Social Security Trustees

But a pay-as-you-go system begins to break down when the number of workers declines in comparison to the number of beneficiaries. The tax burden on each worker rises, and the rate of return on contributions declines.

Over the last several years that is exactly what has happened with Social Security. There were five workers for every beneficiary in 1960. Today there are about three and a half. The ratio will continue to decline as the huge baby boom generation begins to retire in 2008. By 2030, when all but a few boomers will have reached Social Security's normal retirement age (67 in that year), it is projected that there will be only two workers for every beneficiary. As a result, Social Security will weigh more heavily on workers' pay.

According to the 1998 Social Security Trustees Report, between now and the year 2030, the cost of benefits will rise by 60 percent from 11.2% to 17.8% of worker's taxable payroll. By then, Social Security revenues will cover less than three-quarters of promised benefits.

Meanwhile, the program will become an even worse deal for future retirees. For example, an average wage earner retiring in 1980 at age 65 could expect to recover the retirement portion of his combined employer-employee Old-Age and Survivors Insurance (OASI) taxes in less than three years. But it will take more than 15 years for a similar worker retiring in 1998 to recover the retirement portion of his OASI taxes. By 2030, it is estimated that the recovery period will approach 25 years, longer than most people will live after retiring *(see note 1 in the margin).*

The generational subsidy

There is another problem—the current system has accumulated approximately $9 trillion worth of unfunded obligations. This is the amount that today's workers and retirees are due to receive in future benefits over and above current trust fund assets plus what those same workers and retirees are due to pay in future obligations.

In other words, today's adults expect to receive a $9 trillion subsidy from future generations.

One generation does not prefund its own retirement program in a pay-as-you-go system. Social Security's current financing structure requires that workers must always divert a large part of their contributions to paying off the unfunded claims of the previous generation.

Trust fund "assets" do not prefund benefits

Some people may ask about the surpluses that are accumulating in the Social Security trust funds—won't they help pay future benefits? No, they won't.

It is true that the system is now bringing in about $50 billion a year more than is needed to pay current benefits. In other words, we are *more* than paying-as-we-go for now. But the excess Social Security cash is, by law, invested solely in U.S Treasury bonds where it allows the government to borrow less from the capital markets to fund current operations.

A great deal of confusion exists on this point. Many people mistakenly assume that Social Security trust fund surpluses constitute a form of prefunding. They believe that when the system begins running a cash deficit in about 2013 the trust fund's Treasury bonds can be "drawn down" to cover benefit payments.

Unfortunately, that will not be the case. Cash cannot be spent twice, once in 1998 and again in 2013. While the accumulation of Treasury bonds improves the trust fund's solvency on paper, it does nothing to improve the Treasury's ability to pay benefits once the system begins running a cash deficit. The situation has been aptly described by the President's Office of Management and Budget:

> Unlike the assets of private pension plans, [the trust fund balances] **do not consist of real economic assets that can be drawn down in the future to fund benefits.** Instead, they are claims against the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing other expenditures. **The existence of large trust fund balances, therefore, do not by themselves make it easier for the government to pay benefits.**
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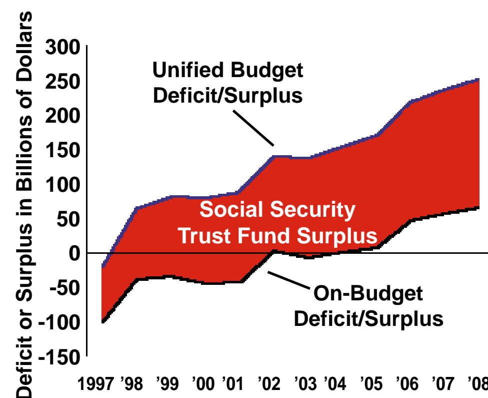
> —*Analytical Perspectives of the President's Fiscal Year 1999 Budget, p. 328 (emphasis added).*



Source: Congressional Budget Office

In the end, there is only one way to enable tomorrow's relatively small workforce to support a much larger number of retirees. That is to boost productivity growth so that each worker produces more goods and services. And that, in turn, means raising our national savings and investment rates—which is why one major objective of most Social Security reform plans is to raise national savings.

Given the prospect of higher taxes, lower benefits, and a massive accumulation of unfunded promises, it is little wonder that younger workers are increasingly cynical about Social Security, retirees are increasingly concerned that the program will impose unfair burdens on their grandchildren, and the nation in general is willing to deactivate the "third rail" in search of reform *(see note 2 in the margin).*

Note 2: For a more detailed analysis of Social Security's long-term challenges see *Saving Social Security: A Framework for Reform, Volume I: Defining the Problem*, released by the Concord Coalition in June 1998. This publication is available in a pdf file on the Concord Coalition's web site (www.concordcoalition.org) or by calling 202-467-6222.

KEY PROBLEMS WITH THE SYSTEM

1. Changing demographics make the current pay-as-you-go benefit structure unsustainable over the long-term.

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.

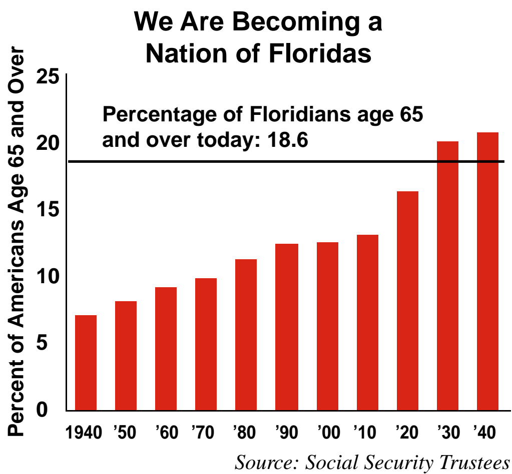
3. Under the current system younger workers will receive an increasingly low rate of return on their contributions.

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.

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.



Source: Social Security Trustees

Why reform is needed sooner rather than later

Preparing Social Security to meet the challenges ahead when the baby boom generation reaches retirement will involve many changes to the existing system. 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:

- According to the 1998 report of the Social Security Trustees, by 2013 the program's annual dedicated revenues will fall short of currently projected benefits. From that point on the government will have to raise the taxes, lower other spending, or borrow from the private sector to meet its obligations to beneficiaries. Reforms enacted now can be phased in over many years to deal with this looming shortfall without sudden and drastic changes.

- 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.

- 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 decision. 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 before retirement, especially if reforms are enacted that require greater reliance on private savings.

II. CRITERIA FOR SOCIAL SECURITY REFORM

The merit of any reform plan should be measured against a set of criteria. Determining in advance what the criteria should be is important because each option has consequences for the system as a whole. Without a vision of the desired result, policy makers and the public will operate in a vacuum.

It is an inconvenient fact that the consequences of any particular reform option may satisfy some criteria while conflicting with others.

For example, raising the payroll tax rate could close Social Security's projected fiscal gap and help maintain current law benefits. But the result of this option would be a significantly higher tax burden on future generations, adverse economic incentives, and a worsening rate of return on workers' payroll contributions.

Similarly, raising or eliminating the cap on taxable wages could quickly add to Social Security's revenues on a progressive basis. But because benefits are calibrated to lifetime earnings, this option would also increase the benefits eventually paid to high-wage workers—ultimately offsetting much of the higher revenue.

In short, no one reform option can be considered in isolation. The ultimate effect on the system as a whole must be considered. And this in turn requires a set of criteria relating the goals of reform to the problems that need fixing.

Concord Coalition's Reform 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 base.

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

The most commonly used measurement of Social Security solvency is its 75-year "actuarial balance," which—according to the 1998 Trustees report—is minus 2.2 percent of payroll. 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.

The problem with this measure of solvency is that it is an accounting fiction. Actuarial balance assumes that the trust fund surpluses accumulated in prior years constitute genuine economic savings that can be drawn down to cover trust fund deficits in future years. They aren't. Since the

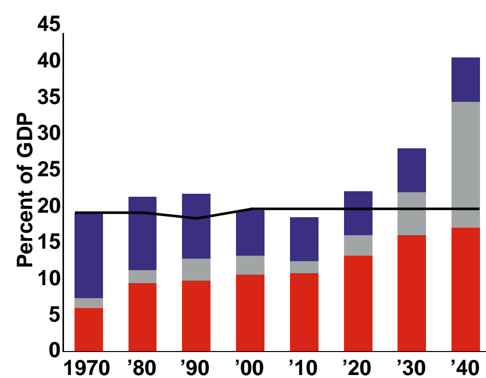
THE REFORM CHALLENGE

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

assets held by Social Security consist of U.S. Treasury securities, when it is time for the trust funds to redeem them around the year 2013, Congress will have to raise taxes, cut other spending, or borrow more from the public to raise the cash.

For that reason, 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 truly be 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.

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 of privately owned accounts.

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

The economy in the future will be called upon 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. The best way to achieve economic growth and increase real income in the future is to increase savings today.

Unfortunately, the savings rate in the United States has declined in recent decades, and is now lower in comparison to most other nations. 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.

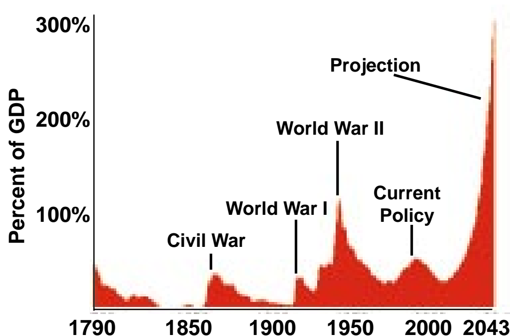
According to most experts, a growing number of new retirees are not getting back the market value of what they paid into the system and the vast majority of tomorrow's retirees will find themselves deep in the red.

Social Security, of course, is not an investment program. Aside from retirement income, 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.

"While people are talking about the year 2032 as the date at which the trust fund is 'exhausted,' 2013 is a more important date. Starting in 2013, we start experiencing a negative cash flow. Cash receipts are less than cash disbursements...so it's actually more immediate than 2032."

— David Walker,
Former Public Trustee of the Social Security and Medicare Trust Funds
"The Great Social Security Debate,"
Kansas City, Mo., April 7, 1998.

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

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

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 generous 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 needed reforms.

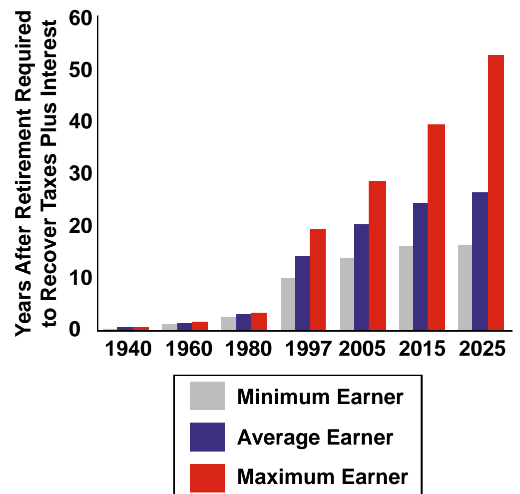
The benefits and costs of any reform should be distributed fairly and equitably among Americans of all ages and income groups. Only the very poor should be exempt from the sacrifices required to solve Social Security's long-term challenges. People with adequate resources who are in their 60s and older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

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

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.

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, economic and administrative assumptions. Almost any plan can appear workable if its assumptions are drawn to fit the conclusions.



Source: Congressional Research Service

"My charge to all of you in thinking about the future is to hold to the principles that I think have made the Social Security system not only very successful but very popular with Americans. That is, to serve as the base of income security and to make sure that it is very stable in that regard."

— Marilyn Moon,
Public Trustee of the Social Security and Medicare Trust Funds
"The Great Social Security Debate,"
Kansas City, Mo., April 7, 1998.

III. WHAT ARE THE OPTIONS?

"I think there's a remarkable agreement among those who have spoken today and among those of you who have asked questions. No one wants to walk away from current retirees. No one wants to walk away from the disabled. No one wants to walk away from a promise that workers don't retire into poverty. And that's the starting point for all of us."

— Fred T. Goldberg Jr., Former Executive Director, Bipartisan Commission on Entitlement and Tax Reform "The Great Social Security Debate," Kansas City, Mo., April 7, 1998.

There is no "best" solution to Social Security's long-term problems. Reform legislation is likely to include a mix of options, and no single combination will result in the "perfect" system. Many difficult decisions will have to be made about the trade-offs that are inherent to any reform in a program as complex as Social Security.

More fundamental however, is the decision that must be made regarding Social Security's basic structure. The basic choices are these:

- Should it remain a totally pay-as-you-go, "defined benefit" program?
- Should it be completely transformed into a prefunded "defined contribution" program?
- Should it be transformed into a partially prefunded "two-pillar" program?
- If partially prefunded, should the prefunding occur within:
  - ➡ the Social Security trust funds or
  - ➡ individually owned defined contribution accounts?
- If partially prefunded in individually owned accounts, should funding:
  - ➡ be carved out of the existing defined benefit program or
  - ➡ be added to the existing defined benefit program?

Essentially, the choice to be made is not between guaranteed future benefits under the current system and a risky path of reform; it is between reform options that, in different ways, attempt to ensure the fiscal sustainability of fair and adequate benefits over the long-term.

The reality is that the present system is unsustainable over the long-term. Some combination of cost cutting or revenue raising must be enacted. The dilemma is that any such combination of reforms would lower the program's rate of return on workers' contributions and/or threaten the adequacy of benefits.

Recognizing this dilemma, many reformers have been looking to the private markets for a solution. On average, private sector investments historically earn a higher rate of return than government bonds. Why not, it is argued, put the private market's rate of return to work for Social Security?

One such approach would be to increase the Social Security system's income by allowing its trust funds to invest excess revenues in the private markets. A different approach would be to allow workers to invest at least a portion of their payroll deductions in individually owned retirement savings accounts.

On the surface, either of these approaches can appear to be a painless solution. But in fact, *neither* represents the "magic bullet" answer to Social Security's problems.

It is, of course, possible that the Social Security system might earn a higher rate of return if part of its assets were invested in something other than government bonds. However, no conceivable rate of return that could be earned by investing the trust funds in private securities would be enough to fund currently projected benefits. Additional revenue or benefit reductions would also be needed.

It is also possible that workers might earn a higher rate of return on their payroll deductions if they were allowed to invest these sums in private accounts. But if workers were allowed to do so, there would be that much less revenue left to pay benefits to those in the current program who are already retired, or who are about to retire. As a consequence, future benefits would have to be lowered to accommodate not only the current projected gap between revenues and benefit promises but also the increased deficit in the program caused by the diversion of payroll contributions into private accounts.

Under either approach, the budgetary impact of investing Social Security revenues in private markets, rather than in government bonds, must be taken into account.

Today, 90 percent of Social Security's income is used to pay current benefits. The remainder is invested in Treasury bonds. The government uses the money to fund ongoing operations, and the Social Security trust fund is credited with interest-bearing Treasury bonds. In effect, this transfers IOUs from one arm of the government to another.

If the annual Social Security surpluses were diverted to the private markets rather than invested in Treasury securities, the government would need to borrow from the capital markets to make up the difference. While such an asset shuffle might improve the outlook for Social Security, the bottom line for the nation as a whole would not change *(see note 3 in the margin).*

Defined Benefit, Defined Contribution: Two Fundamental Approaches to Reform

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. The pension program bears the risk of having to come up with more money if assets prove too little to finance promised benefits.

In contrast to the defined-benefit model, many private sector retirement plans have begun using the "defined contribution" model, such as the 401(k) plans that have soared in popularity. Defined-contribution plans simply give workers the market return on their contributions, less any administrative costs. The workers bear the risk that their accumulated assets may not be sufficient to finance anticipated benefits.

Portions of the Payroll Tax Are Earmarked For Old-Age, Survivors Disability, and Health Insurance

	Employee	Employer	Self-Employed
Old-Age Survivors Insurance (OASI)	5.30	5.30	10.60
Disability Insurance	0.90	0.90	1.80
Health Insurance	1.45	1.45	2.90
Total	7.65	7.65	15.30

Source: Social Security Trustees

NOTE 3: The situation would be different, of course, if the President and Congress were to undertake policies to ensure that the federal budget could be balanced without relying on annual Social security surpluses. Such action would be prudent in any event since those surpluses will begin to shrink in 2002 and are expected to disappear altogether by 2013.

DEFINED BENEFIT: A benefit model that 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.

IV. CHANGES WITHIN THE CURRENT DEFINED BENEFIT PROGRAM

One approach to reforming Social Security would be to continue to rely exclusively on a pay-as-you-go 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 or wage base increases, reductions in the cost of living adjustments, gradually increasing the retirement age, means-testing benefits, or changing the formula for determining initial benefits could be phased-in to close the financial 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 above. Increasing payroll taxes would provide an even worse rate of return on contributions than what future beneficiaries can expect under the current system. Alternatively, across-the-board benefit reductions would risk putting some older Americans into poverty.

Another option within the defined benefit structure would be to shore up the Social Security trust fund by investing a portion of its payroll tax revenues in private capital markets. This would introduce an element of prefunding into the current program without creating individually owned accounts.

A number of possible changes to the current defined benefit Social Security system are described in the appendix. These changes, when boiled down to their essentials, involve either bringing more income into the Social Security system or reducing promised benefits. To make the system sustainable throughout the baby boomers' retirement years and afterwards, a combination of several of these options would have to be adopted.

OPTIONS WITHIN THE CURRENT SYSTEM

Increasing Revenues

1. Increase the payroll tax rate.
2. Increase wage base on which payroll tax is applied.
3. Tax benefits the same as other pension income.
4. Require state and local government employees to participate in Social Security.
5. Invest trust fund assets in equities.

Reducing Promised Benefits

6. Increase the Social Security retirement age and/or early retirement age.
7. Impose a means test to scale back Social Security benefits for retirees with well above average incomes.
8. Reduce cost of living increases for all beneficiaries.
9. Reduce initial benefits across-the-board for future retirees.
10. Increase number of years used to calculate initial retirement benefit.

(number indicates the order of the option explanations in the appendix)

V. DESIGNING A DEFINED CONTRIBUTION PLAN FOR SOCIAL SECURITY

The problems inherent to Social Security's pay-as-you-go financing are leading many to conclude that the program should be transitioned into a funded or partially funded system in which some portion of Federal Insurance Contributions Act (FICA) tax contributions are saved and invested in individually owned accounts.

DEFINED CONTRIBUTION: A benefit model that gives workers the market return on their contributions, less any administrative costs.

Properly designed, such a system could have enormous benefits, such as potentially higher returns on contributions, greater national savings and productive investment, and hence greater wage growth for workers in the years before retirement.

There is also the issue of private ownership. The current system provides a mere statutory right to benefits that Congress can cut at some future date. And, at death, workers cannot bequeath Social Security benefits to their heirs. On the other hand, individually owned accounts would offer workers ownership of constitutionally protected property, which could be passed on to their heirs.

The challenge of moving to a funded or partially funded 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. Unless a reform plan faces up to this transition cost, it will not result in net new savings or a larger economy. Any gains for future beneficiaries will necessarily come at the expense of future taxpayers.

In short, there is no free lunch.

Without ***new*** savings, without ***real*** funding, as opposed to trust fund financing, a plan cannot increase the productivity of tomorrow's workers, and thus becomes a zero-sum game of pushing liabilities from one pocket to another or from one generation to another.

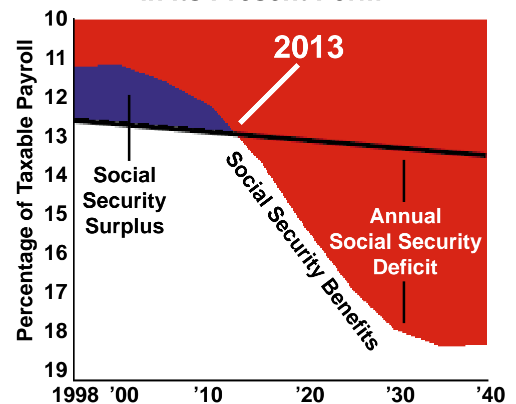
A Checklist of Questions

How should a defined contribution plan for Social Security be designed? The following questions are a checklist of choices that must be made. It is assumed in the following discussion that all assets accumulated in defined contribution accounts will be personally owned, and that contributions will be collected through the present system of payroll deductions.

1. Would a defined contribution component threaten the adequacy of Social Security benefits?

Social Security's defined benefit structure has always attempted to balance "equity" and "adequacy." Equity is the idea that every retiree will receive benefits that are directly linked to the amount of his or her prior contributions. Adequacy is the idea that low-income workers should get a somewhat better deal from a public program than high-income

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

workers so that every retiree has an adequate standard of living. Both principles appeal to most Americans.

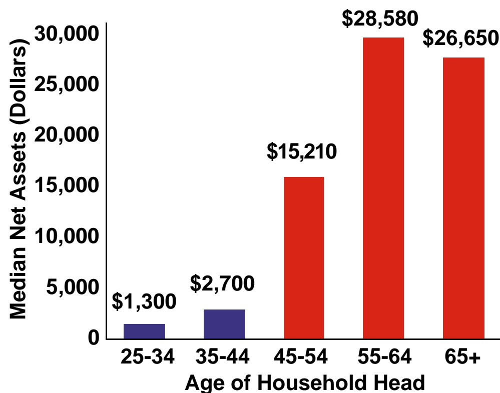
A defined contribution system meets the equity standard since the benefit return is exactly equal to the market worth of prior contributions minus administrative costs. But what about the adequacy standard?

One method of achieving adequacy in a reformed system would be to target future Social Security cuts at high-income workers. Such cuts might include lowering the initial benefit of high-income wage earners, means-testing benefits on a graduated scale, capping the dollar amount of each year's cost-of-living adjustment (COLA), and making more of Social Security income taxable.

By making the current system less important for the affluent, these options tend to neutralize the income impact of the defined contribution element which would distribute benefits entirely in proportion to contributions and thus increase the return for higher income contributors.

In assessing the adequacy of benefits under a reformed system (including both defined benefits and defined contributions) it must be kept in mind that a person's retirement income would come from ***both*** sources—a basic level of guaranteed benefits from a scaled-back defined benefit program and an additional benefit financed from the lifetime accumulation of the individually owned account.

Excluding Housing, the Average U.S. Household has Accumulated Few Financial Assets



Source: PowerPoint Presentation "The Great Social Security Debate" Cranston, R.I., July 1, 1998

2. Would a defined contribution component threaten the social safety net?

Closely related to the question of adequacy is whether a defined contribution plan can maintain Social Security's vital floor of protection.

Although the poverty rate for the elderly in the U.S. has fallen dramatically over the post-WWII era, a sizable share (over 10 percent) remain below the official poverty line. Any plan that aims to restructure Social Security should ask the question: while improving the fairness, generosity, and efficiency of the system., shouldn't reform also do more to achieve one of the program's earliest goals by providing a genuine "floor of protection" for all elderly?

Disability insurance (DI) is an important part of the overall Social Security system. Most Social Security reforms, however, treat DI as a separate program whose insurance function and administration are very different from the retirement and survivor portion of Social Security.

3. Should the new system be mandatory?

In most of the Social Security defined contribution proposals, participation in the new system would be mandatory. In some plans, however, participation would be voluntary.

Given that Americans seem to like the idea of choice, voluntary participation may be a political selling point. Mandatory participation is necessary, however, to boost national savings and to ensure that workers

build meaningful assets in their defined contribution accounts. To date, voluntary savings incentives such as 401(k) plans and Individual Retirement Accounts (IRAs) have met with mixed results. Proponents of mandatory accounts point to this experience as evidence that participation in any new system must be mandatory to ensure that personal savings will actually increase.

4. How much government regulation should there be?

Because no plan can allow contributors *complete* freedom, including the discretion to liquidate the account on demand, defined contribution plans are often described as a form of legal trust which manages assets on behalf of the owners. These trusts can be designed with legal and regulatory constraints to maintain important protections.

How much constraint? The answer varies a great deal among proposals. Some specify very rigid constraints, intended to further society's interest in minimizing investment risk and averting insufficient benefits. Others allow far more discretion, intended to further the individual's interest in maximizing choice.

The constraints usually focus on four basic issues:

a. Private or public fiduciaries?

Should workers have the same flexibility to choose account managers that they enjoy for their IRA and 401(k) plans, or should the government administer the accounts directly?

b. Deposits and withdrawals

Should workers be given the option of depositing more than the "defined contribution" share of FICA into their accounts? Most plans allow this in a limited form. What conditions should be set for withdrawals? Most plans allow no withdrawals until a fixed age, typically 59.5, 62, or 65. As for the form of withdrawal, some would require a fixed annuity while others would put virtually no restrictions on the form of withdrawal.

c. Asset management

The controls on investments in various plans vary from fairly permissive IRA/401(k) type regulations to very limited options in government managed and directed investment pools. Several proposals require age-appropriate risk levels so that as participants grow older, more of their assets would be invested in risk-free or near risk-free debt. Simulations have shown that such portfolio rules could help protect workers nearing retirement from market declines.

d. Spousal ownership

Most married couples function as a single household economic unit, sharing income and assets. Pension law, and Social Security, recognize the claim one spouse has to a portion of the retirement income

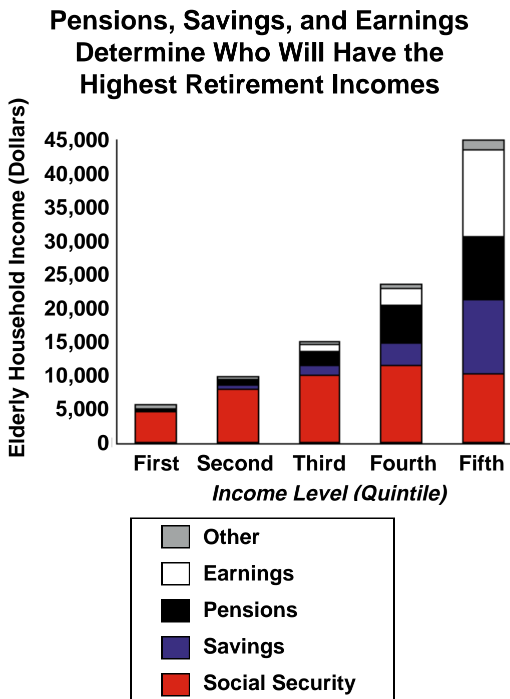
INDIVIDUAL ACCOUNTS WOULD NOT "PRIVATIZE" SOCIAL SECURITY

Many Social Security reform plans would either completely transition the program into a defined contribution plan, or combine a scaled-back version of the present defined benefit program with a new defined contribution element. Each of these plans would, for the first time, allow or require workers to invest a portion of their payroll tax contributions in individually owned accounts.

Frequently, these plans are mistakenly referred to as "privatization" because workers would acquire a private ownership interest in at least part of their contributions—something they do not have now. None of the plans, however, would truly privatize Social Security.

In all of the proposed defined contribution plans workers would continue to have contributions withheld from their paychecks. In most plans, market risk would be limited by narrowing the investment options. Fund management would be done either by a government agency, such as the Social Security Administration, or by regulated private sector fund managers. No withdrawals would be permitted before retirement, death, or disability, and many would regulate withdrawals by requiring annuitization to protect survivors and to prevent squandering of assets. Finally, almost all defined contribution proposals would retain some level of minimum benefit.

of the other, particularly in the case of divorce, and Social Security provides spousal benefits to the lower earning spouse in a couple. Should the same be true for individually owned Social Security accounts? Should account assets be individually or jointly owned?



Source: General Accounting Office

5. What percentage of pay should be devoted to the defined contribution plan?

The size of the contribution to defined contribution accounts varies widely among the proposals—ranging from a modest one percent of payroll all the way up to ten percent.

The advantage of a small plan is that it minimizes the total burden placed on taxpayers and contributors, and preserves a large share of the current Social Security system. Some proponents of small plans believe it is the most that can be hoped for politically; that over a working lifetime even small contributions can produce sizeable benefits; and that as the public grows more comfortable with the new system it can be expanded.

Advocates of larger plans argue that introducing a new system requires a critical mass of resources sufficient to swiftly and adequately replace the current system with a superior one. They believe that in the long run it is best to enact major changes now and pay for the transition costs up front.

Of course, it would be possible to take a small first step now with planned expansion over time. The perceived advantage of this approach is that it preserves much of the current benefit structure for those near retirement age while still committing the nation to a more sustainable system in future decades for younger workers.

6. Should the contributions replace or be added to the existing Social Security tax?

Again, the proposed plans vary a great deal. Several plans would add new mandatory contributions on top of the existing FICA. These plans have been referred to as "add-ons." Other plans rely on diverting some or all of the existing FICA into the new defined contribution system. These plans are referred to as "carve-outs."

As an example of how each would work, assume that two percent of taxable payroll is determined to be the appropriate size of the new defined contribution plan. The two percent could be added to the existing 12.4 percent FICA, resulting in a 14.4 percent payroll deduction for Social Security, or it could be diverted from the existing FICA, leaving it at 12.4, but resulting in less money to fund benefits promised under the current system.

It is also possible that a blended approach could also be used—adding one percent to the FICA and diverting one percent from the existing FICA—resulting in a 13.4 percent payroll deduction.

In each case, the defined contribution amount would be the same two percent of taxable payroll. The differences would be the amount remaining to finance the remaining defined benefit system, and the total payroll deduction.

Example:

	Current FICA Rate	Defined Contribution FICA	Defined Benefit FICA	Total FICA
Add-on	12.4	2.0	12.4	14.4
Carve-out	12.4	2.0	10.4	12.4
Blend	12.4	2.0	11.4	13.4

The clear disadvantage of an "add-on" is that it directly increases the total tax-plus-savings contribution rate on workers' earnings. Many reformers believe this ruins its political appeal.

The clear advantage of an add-on is that it confronts openly and directly the question of where the extra economic savings are coming from to fund the new accounts. Add-on plans do not entail a large debt overhang and/or large tax hikes or spending cuts elsewhere in government.

The advantage of a carve-out is that the total payroll deduction does not go up. This is a powerful political selling point. The downside is that it leaves less money available for the remaining defined contribution system, meaning that future benefit cuts must be larger, or significant debt must be incurred to finance the remaining defined benefit program.

7. Will the new system raise national savings?

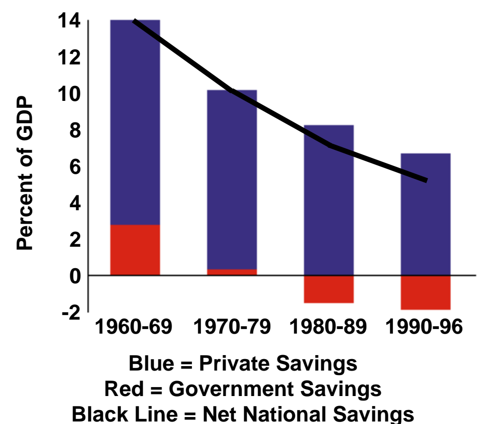
Today's public policies, including Social Security reform, should be directed at building national savings and investment to spur the productivity increases needed for tomorrow's labor force to support the retirement and health care costs of the population's much higher percentage of retirees.

The primary effect of any plan's impact on national savings varies directly, in each future year, with the size of the plan (i.e., the percent of payroll workers contribute to their defined contribution account) minus any extra government deficit caused by the plan.

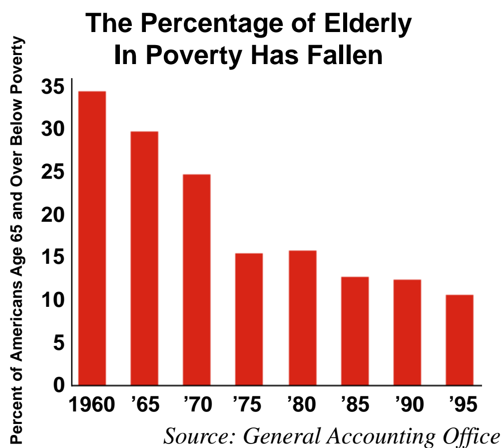
It cannot be assumed, however, that the entire defined contribution amount will add to national savings. Some workers would undoubtedly save less in other areas if forced to contribute more through a payroll deduction. The actual offset would depend critically upon the extent to which households see the new system as a substitute for other forms of voluntary savings. For below-to-median income households without pension coverage, the offset may be negligible since most of these households can't save much less than they do already. But for more affluent households, the offset may be sizeable.

"What we need is a platform, a universal foundation that working people can use to build their own wealth, to create their own dreams. We have to find ways that working men and women can create some measure of wealth, so that they can care for themselves, they can care for their parents, they can care for their kids, they can pass on their dreams through charity. I think you keep the basics, but a modest system of universal private accounts creates a platform to build wealth."

— Fred T. Goldberg Jr.,
Former Executive Director,
Bipartisan Commission on
Entitlement and Tax Reform
"The Great Social Security Debate,"
Kansas City, Mo., April 7, 1998.



Source: Department of Commerce data



Source: General Accounting Office

8. To what extent would the new plan require financing from outside the Social Security system?

In and of themselves, add-on plans would require no transition costs or financing outside the Social Security system. Transition to a large-scale carve-out defined contribution system would impose a hefty cost. With so much revenue being diverted from the current system, the government would need to raise a huge sum of money to pay the benefits of current retirees and those soon to retire.

This can be done in three ways. One is to collect the money entirely on a pay-as-you-go basis either through a temporary new tax that would phase out as government benefits decline, or through the use of a budget surplus. A second method is to borrow the money, issuing "recognition bonds" to people still in the workforce, which become a form of federal debt, to represent their accumulated benefits. These bonds would be paid off by future generations. Third, the federal government can use a combination of a new tax and added borrowing, keeping the tax at a lower level than needed to fully cover program costs, but continuing to collect it after it is no longer needed to pay for benefits, using the revenue to pay down the federal debt accumulated in the first few decades.

To the extent that additional borrowing is needed, interest costs for the federal government will rise. This might drive up interest rates and, because so much of the current federal debt is financed through short-term bonds, could even raise costs well beyond the amount needed to finance new debt. In addition, the new debt would be counterproductive because it would offset the gains from private savings, leaving national savings no higher than pre-reform levels. Raising taxes would alleviate the burden of new debt but would be similarly harmful both economically and politically.

A smaller carve-out would involve a smaller transition cost. Moreover, since there is currently a Social Security surplus, a small carve-out can be accommodated without deficits in the system. In an indirect way, such a change might be beneficial because it could force policymakers to stop relying on temporary Social Security surpluses to offset deficits in the rest of the budget. Still, the government would need to borrow more from the private sector to replace the lost revenue from Social Security (or, in case of surplus, retire less debt than might otherwise be possible).

9. Are the numbers and assumptions credible?

Before deciding whether the whole idea of a defined contribution element for Social Security is sound, or choosing among the various plans, it is not possible to proceed without looking closely at the underlying assumptions, economic and otherwise. This entails a number of calculations, and unfortunately, no clear and quantitative answers can be definitely given, if for no other reason than there is no settled consensus among experts on these questions.

Without attempting to settle any of the various debates, the following are among the most at issue:

A. The real rate of return

Without doubt, this is the most critical and disputed assumption. Opponents of a defined contribution element insist that proponents are using optimistic estimates, while proponents claim that the other side is deliberately understating the likely gains. Moreover, many plans assume the entire defined contribution account would be invested in stocks, a decision which many financial advisors consider to be unwise.

For the 1994-1996 Advisory Council on Social Security, the Social Security Administration (SSA) estimated that, based on a century of historical experience, the real (after inflation) return on stocks in the future would be 7 percent, and the real return on federal government bonds would be 2.3 percent. A reasonable mixed portfolio should then offer a real return of between 4 and 5 percent, minus administrative costs.

Respectable arguments can be made for a higher or lower number based on whether the stock market will continue growing rapidly or whether it will decline as boomers start selling assets to fund their retirements. A prudent analysis should take the range of possibilities into account when estimating the gains from investment.

B. Administrative costs

Annual administrative costs of the current Social Security system amount to approximately one percent of benefit payments. Higher administrative costs are inevitable with defined contribution plans. The present system has a single manager, a single investment in its portfolio (Treasury bonds), a single account for all 147 million insured workers, minimal reporting requirements to participants and no marketing costs.

A defined contribution component for Social Security would be quite different. Conceivably, each worker could have several fund managers, numerous portfolios and accounts, and frequent asset transfers. Plan managers would be required to report periodically, and would have investment-management, client service, and marketing costs.

Unconstrained administrative costs could become excessive and reduce the rate of return on defined contribution accounts. SSA estimated that the administrative costs for a defined contribution plan could shave a full percentage point off the annual return on investment, and some have estimated even higher costs. But many reformers have proposed ways to minimize administrative costs. For example, the federal government could remain as fund manager, investment options could be limited to a few stock and bond index funds with a default option administered by the government, and allowable fees could be regulated.

C. The "spread" between stocks and bonds

This equation looms large in any plan that issues large amounts of debt. On average, stocks earn a higher rate of return than bonds. Economists refer to this difference as the "spread." Many reform plans assume that the federal government can borrow at a relatively low interest rate, put the money into workers' accounts where it will earn a much higher

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.

The FICA Tax Rate has Grown Larger Over Time

Calendar Year	Contribution Base	Contribution Rates % OASDI*	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

rate, and rely on the difference to make up for reduced benefits under the defined benefit portion of Social Security. This is called "playing the spread," and some reformers have used it to construct debt-financed plans that appear to phase in fully funded defined contribution accounts with no visible cost to anyone.

Yet many objections have been raised against plans that play the spread. If the government starts buying stocks and selling bonds on a large scale, the return on bonds will rise and the return on stocks will fall, narrowing the favorable spread on which the plan depends. Moreover, the very fact that the government is betting on the stock market to defray the cost of future benefits will increase the risk of government default and hence the interest cost of government debt. This narrows the spread even more.

Finally, if FICA contributions were put into personal accounts, the extra interest payable to new government debt holders could largely cancel out the risk-adjusted return to account holders. In the long run, this revolving door is unlikely to leave society better off. Workers may well earn a higher rate of return on defined contribution accounts than what is now in store under the current program, but any plan that relies on the spread between stocks and bonds for success is a chancy proposition.

Looking Ahead

Today's Social Security system is more than adequate to meet its obligations to those who are already retired. Indeed, today's retirees, on average, will get a better deal from Social Security than any category of similarly situated retirees will enjoy in the future. And, while the baby boomers can expect less generous benefits relative to their payroll contributions than their parents now enjoy, fairly modest changes could be enacted to keep the current system solvent for most boomers.

But what of the so-called Generation X'ers, those born in the post-boom "baby bust" years of the late Sixties and Seventies? And, what of today's children, those who are now relying on their baby boomer parents and WWII generation grandparents to leave behind a growing economy, to say nothing of a secure retirement system?

Too often, it is the young who are overlooked in the Social Security reform debate. And yet, today's young people are the ones who are expected to pay the higher taxes, accept the lower benefits, and bear the burden of debt incurred between now and their "golden years" to keep the current pay-as-you-go system going for their elders.

In the end, Social Security reform is about the young. It is about today's workers and retirees exercising stewardship over the future, and preserving the sacred trust of generational responsibility.

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NOTE ON COMPARATIVE IMPACT GRAPHIC FOUND ON THE ABOVE PAGES

The graphs that appear in the upper right corner of pages 20-28 are designed to show the comparative fiscal impact of each option. The taller the line, the greater the impact. For example, imposing a graduated means-test would have a greater fiscal impact than including all new state and local workers in the Social Security system.

The charts ***are not*** *intended to reflect a judgement on the policy implications of the options. It should also be kept in mind that some options would impact workers while others would impact beneficiaries, either now or in the future. Similarly, some options would begin to take effect immediately while others would be phased in over many years.*

Specific numbers are not given in the charts above because there are many different ways of measuring Social Security's long-term shortfall. But, regardless of the standard used, it is clear that some options get more "bang for the buck," which is what the charts are intended to show.

Description of Social Security Defined Contribution Options

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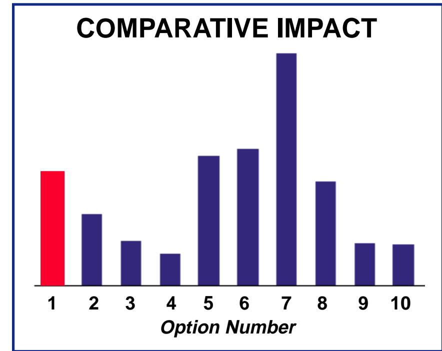
1. Increase the Payroll Tax Rate

CURRENT LAW: The 12.4% payroll tax that finances Social Security is split equally between employees and employers. It applies to all wages up to a certain limit ($68,400 in 1998) which increases at the same rate as average wages.

OPTION: Raise the combined employee-employer payroll tax rate by 2.0% in 2030. Variants of this option would raise the rate by different amounts at different times.



PROPONENTS SAY:

- People's incomes and living standards are expected to rise in the next century, so future workers will be able to afford the tax increase.
- FICA taxes are best viewed not as taxes but as contributions toward social insurance which protect everyone in their old age.

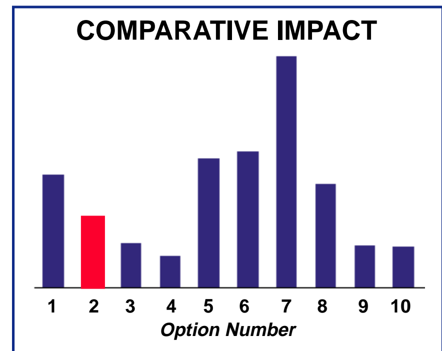
OPPONENTS SAY:

- The payroll tax is regressive, applying to the first dollar of income for rich and poor alike. Raising it would be unfair to low-income people.
- Payroll tax rates are already too high. Almost 75% of taxpayers pay more in FICA taxes than they do in income taxes.

2. Increase the Payroll Tax Base

CURRENT LAW: The 12.4% payroll tax that finances Social Security is split equally between employees and employers. It applies to all wages up to a certain limit ($68,400 in 1998) which increases at the same rate as average wages.

OPTIONS: Raise the cap to $121,000 by 2002 and index it as under present law. This option would tax 90 percent of the wages earned. Another version of this option would remove the cap completely. Based on the current benefit formula, benefits would be increased somewhat in the long run because more wages would be included in the calculation of benefits. Some advocates for removing the cap, however, recommend changing the formula to keep benefits at current levels.



PROPONENTS SAY:

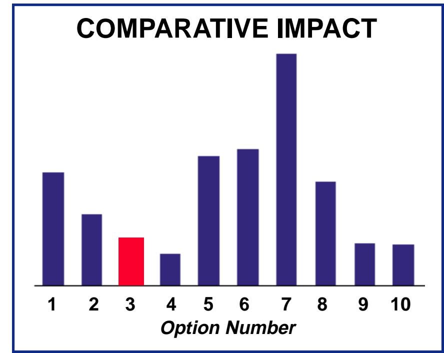
- Those who earn more than the cap pay a smaller percentage of their income in payroll taxes. Applying the payroll tax to all income would eliminate its regressivity.
- Social Security is necessary to lift the elderly out of poverty and should not be substantially trimmed. Raising payroll taxes, especially on those who can most afford it, is less harmful than cutting benefits.

OPPONENTS SAY:

- Because Social Security benefits are linked to taxable wages, raising the cap would lead to higher benefits for wealthy people. If benefits did not go up for the wealthy along with the wage-base increase, Social Security's historic link between wages and taxes would be broken.
- Because benefits are linked to taxable wages, raising the cap would lead to higher benefits for the wealthy—an odd result.

3. Treat Social Security Benefits Like Private Pensions for Tax Purposes

CURRENT LAW: Couples earning $32,000 in income have 50% of their benefits subject to taxation. Above $44,000 in income, 85% of benefits are taxed. For single persons, the corresponding thresholds are $25,000 and $34,000.



OPTION: Tax Social Security benefits in the same way that private "defined benefit" pensions are currently taxed. That is, tax would be applied to the amount of benefits that exceed the dollar amount of employees' payroll taxes paid in, avoiding "double taxation." This dollar amount would be calculated individually for each retiree and would not include interest.

BACKGROUND: The elderly as a group pay far less in federal taxes than working-age adults. For example, a couple with one child earning $30,000 pays $6,900 in federal income and payroll taxes, but a retired couple with income of $30,000 pays only $600.

Most federal benefits are excluded from income for the purposes of the income tax. Of other major entitlement programs, unemployment compensation is subject to income tax, but Medicare, Medicaid, veterans' benefits, cash welfare and related benefits, and non-cash benefits such as food stamps are exempt from taxation.

For the most part, the overriding principle is that federal payments to individuals are subject to income tax if they represent or replace a regular paycheck. Income support payments are exempt from tax because their direct purpose is to raise the standard of living for the poor. From this standpoint, whether to tax Social Security benefits is not a clear choice, because the program serves dual purposes. Social Security is designed as a safety net for the poor and also serves as a replacement for wages after retirement.

PROPONENTS SAY:

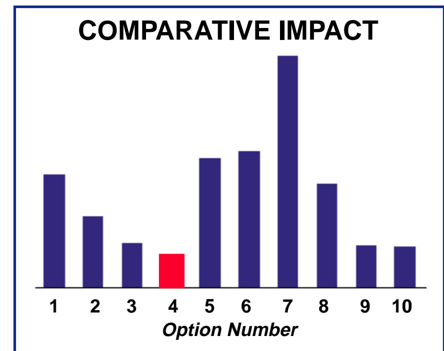
- A worker earning $30,000 of income should be treated the same as a retiree with an income of $30,000. This proposal makes the tax system more fair.
- Taxing private income more than government benefits amounts to preferential status to income from government programs.
- Because the income tax is progressive, with a substantial individual exemption, poor people would not be overly burdened by this change.

OPPONENTS SAY:

- Social Security benefit amounts have been set to give a particular amount of real income or benefit to recipients. Raising taxes on these benefits is equivalent to lowering the benefit payment.
- Fully taxing entitlement benefits would be a violation of our social contract.
- Benefits are already taxed for those with above-average incomes. This proposal would increase taxes disproportionately on lower- and middle-income recipients.

4. Require Social Security Coverage of New State and Local Employees

CURRENT LAW: Currently many state and local employees are enrolled in their own government's pension system in lieu of Social Security.



OPTION: Require Social Security coverage of all new state and local government employees. This option would not affect those already enrolled in such a system but would mandate that any new employees hired by those governments must join Social Security.

BACKGROUND: When Social Security was originally enacted, employees of state and local governments were not included in the system. At the time, it was judged that including employees of other governments would be unconstitutional because imposing mandates on state and local governments would violate the federalist principle.

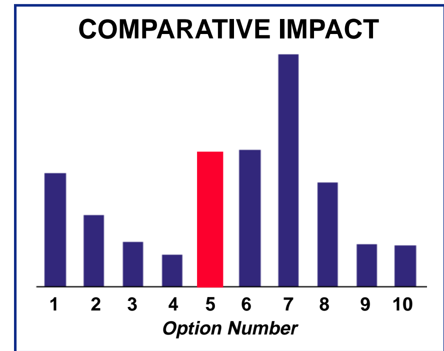
Instead, state and local governments were allowed to contract voluntarily for Social Security coverage for their employees or come up with their own pension systems. In addition, federal employees were also exempted from Social Security, and were covered by a separate federal pension system.

However, court decisions over the years, particularly in the realm of labor law, have implied that extending Social Security coverage to state and local government employees would not be unconstitutional. And, as part of the 1983 reform of the federal pension system, Social Security coverage was extended to all new federal employees for the first time in return for a reduced federal pension.

Budget savings come from increased tax payments from newly-covered workers. Increased spending for these workers when they retire would offset some of the increased revenue in the long run. State government pension systems might be disrupted as they would have to continue paying benefits for former employees in retirement with lower contribution from current employees, assuming that pension contributions would be reduced (as was done with federal pensions) to avoid a double burden on employees.

PROPONENTS SAY:	OPPONENTS SAY:
• One of the original goals of Social Security, indeed one of the precepts of social insurance generally, is universal coverage. This is the final step toward achieving that goal. • Many state and local government employees work for private employers at some point in their lives, and therefore will get Social Security benefits anyway, so they should be paying their fair share into the system.	• People who aren't enrolled in Social Security are likely to be getting a better deal from their own pension plan, so bringing them into the Social Security system would probably make them worse off. • This option would cause undue disruption of existing state and local pension systems.

5. Allow the Social Security Trust Fund to Invest in the Private Market



CURRENT LAW: The Social Security Trust Fund is not a separate fund with real assets; it is more like an account balance with the Treasury. Any surplus Social Security funds are "deposited" in the Treasury and credited to the trust fund. The fund receives Treasury bonds to represent the amount kept by the Treasury plus interest on the balance which the Treasury also credits. The Treasury keeps the cash to reduce the amount that it needs to borrow from other sources in the present, but the government will need to find money in the future to pay back Social Security when the program starts running a deficit.

OPTIONS: Instead of acquiring Treasury bonds, the Social Security Administration (SSA) would invest some of the Social Security surplus in private sector financial instruments, such as the stock market. Most proposals would allow the Social Security Administration to invest 40% to 50% of its total fund balance in stocks. Some suggest retaining only enough money in bonds to pay about 1.5 years' worth of benefits (slightly less than the current level) and investing the rest. Investments would be made in a broad-based index fund of large corporate stocks. Many have suggested setting up an independent board, like the Federal Reserve Board, whose members would be appointed to be in charge of making investment decisions for Social Security.

BACKGROUND: When the Social Security Trust Fund was created, Congress required that any trust fund balance must be invested in federal government bonds. Congress wanted Social Security's money to be kept in as risk-free a place as possible while still earning a reasonable rate of interest.

Because the boomer generation is so much larger than other generations, changes enacted in 1977 and 1983 increased the payroll tax beyond what would be necessary just to keep the program in balance, to save up money to help pay the benefits of the retiring boomers. (Unfortunately, because of the large budget deficits in the 1980s and early 1990s, these surpluses in the Social Security system were not truly saved but instead were used to offset part of the non-Social Security deficit and reduce federal borrowing.)

As the trust fund grew, the need to have virtually risk-free holdings subsided, since the money would not immediately be needed to pay benefits. Meanwhile, concern developed about the relatively low yield from federal bonds.

PROPONENTS SAY:

- This would reduce the amount that taxes would otherwise have to be raised or benefits to be cut to save the system.

- The government is able to manage risk effectively and ride the ups and downs of the market without cause for concern. By contrast, individual investment in personal accounts could leave a retiree with less money than expected if there was a bear market.

- Pension funds in the private sector and in many state and local governments improve their return through investments in stocks. Why shouldn't Social Security?

- The administrative costs for this proposal are far less than for any individual accounts plan.

OPPONENTS SAY:

- This is a very risky idea. Government decisions would affect many businesses and might lead to financially favoring politically popular ones or exerting political influence on private companies.

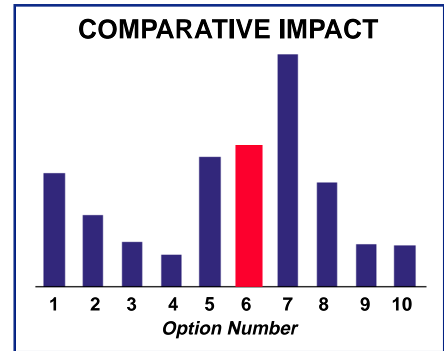
- It's a bad idea to have the federal government to be the single largest owner of corporate stock.

- This option just shuffles assets around. The government would have to issue more bonds to replace the money spent on stocks. Since this would raise interest rates while demand for stocks could lead to lower returns, this option may not raise much money.

- Social Security was founded because many pension funds collapsed in the stock market crash. Let's not repeat the same mistake.

6. Increase Social Security Retirement Age

CURRENT LAW: The normal retirement age is currently 65, but is scheduled to increase to 67 by 2022, at which point the prorated reduction for those who retire at 62 will have increased to 30% from 20% today.



OPTIONS: Raise the normal retirement age gradually to 70 by 2029. Some variants of this option would also index the normal retirement age to life expectancy thereafter. Seniors would still be able to begin collecting Social Security benefits any time after age 62, the early eligibility age, but with benefits reduced based on the amount of time between the date of retirement and the date that the recipient would reach the normal retirement age.

BACKGROUND: When Social Security was enacted, benefits were unavailable to those below the "normal retirement age" (NRA), originally set at 65. In 1962, Congress allowed all retirees to begin collecting benefits at an early eligibility age (EEA) of 62; but their benefits would be reduced based on their age upon retirement. Those who retired at 62 would get 80% of their defined benefit, for example, and those who retired at 64 would get 93.3%. The amount of reduction is set, actuarially, so that recipients are expected to get the same amount of total benefits over a lifetime no matter when they choose to retire.

Life expectancy has gone up substantially since the normal retirement age of 65 and the early eligibility age of 62 were established. In 1983, a gradual increase in the normal retirement age to 67 was enacted, but not affecting anyone born before 1938 (see chart below). The new normal retirement age of 67 would not kick in fully until 2022. The early eligibility age of 62 would not change, but the actuarial reduction in benefits would gradually increase from a 20 percent reduction at present to a 30 percent reduction when the new normal retirement age was fully phased-in.

CURRENT-LAW INCREASE IN NORMAL RETIREMENT AGE (NRA) FOR SOCIAL SECURITY

Year	EEA	NRA	Prorated reduction for retirees at age 62
1962-1999	62	65	20%
2000-2005	62	increased by 2 mo. each year	increased by 5/6% each year
2005-2016	62	66	25%
2017-2022	62	increased by 2 mo. each year	increased by 5/6% each year
2022 and later	62	67	30%

Source: House Ways and Means Committee

PROPONENTS SAY:

• Since Social Security was first enacted, life expectancy has gone up from 61 to 78. Life expectancy for those who reach age 65 has gone up from 13 to 19 additional years.

• The choice of 65 for a retirement age was arbitrary in the first place. There's no reason why that should be set in stone.

• Rising life expectancy is one of the primary reasons why there is a Social Security financing problem; raising the retirement age is therefore one of the most obvious, rational ways to help solve it.

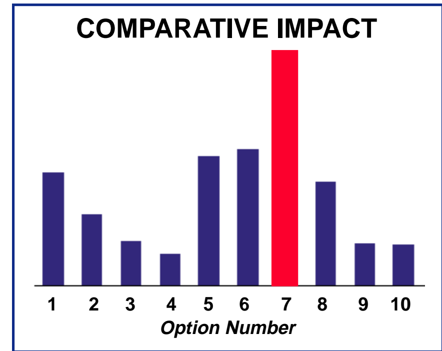
OPPONENTS SAY:

• Not everyone is living and working longer. Asking many blue-collar employees to work longer is unreasonable, and these are the people who need Social Security the most. Also, it is difficult for people who lose their jobs involuntarily between, say, 55 and 65 to find additional work before they qualify for Social Security.

• Most people retire long before age 65 anyway. To most people a hike in the retirement age is just a benefit reduction in disguise.

• We should wait to see how people deal with the currently-scheduled increases in retirement age before we increase it further.

7. Impose a Gradual Means Test on Social Security



CURRENT LAW: Social Security benefits are currently based on a formula that takes into account only the recipient's past wages.

OPTION: Impose a gradual means test on Social Security, reducing benefits by a percentage for households with retirement incomes of $40,000 and more. Other variants of this option would start the means test at income levels of $35,000 or $50,000.

BACKGROUND: Although the term "entitlement" often conjures up the image of welfare recipients and anti-poverty programs, most entitlement benefits go to the middle-class, not to the poor. Although many entitlement programs that give substantial benefits to the middle class do help lift people out of poverty, much of the spending goes to people who are not at risk of becoming poor. In 1990, the 42% of all families with $30,000 or more in income received 36% of all entitlement benefits.

Some have advocated means-testing entitlements to reduce spending on those who do not need it. One particular form, sometimes called an "affluence test," would set out income-related criteria for receiving entitlement benefits. Instead of basing Social Security benefits wholly on a recipient's past wages, this proposal would withhold a portion of the benefits based on a recipient's expected total income for the year, with adjustments at the end of the year that could be filed with one's income tax return.

The underlying philosophy of this proposal is that the government cannot afford to pay benefits to those who don't need them. This conflicts with the principle of social insurance that now underlies programs like Social Security and Medicare, where everyone contributes during his or her working life and everyone receives benefits when retired, regardless of need.

ADDITIONAL DETAILS

Under this means-test proposal, the benefit reduction would rise gradually for incomes above the initial threshold level. Only the benefits that caused a household's benefit to exceed the threshold level would be reduced. The reduction would be 10 percent of the first $10,000 of benefits that caused income to exceed this level, plus an additional 10 percent benefit reduction for each additional $10,000 increment above that. However, benefits would not be reduced more than 85% in any case, a level reached at an income level of $120,000 per year.

PROPONENTS SAY:

- This is the fairest way to reduce Social Security spending. It retains benefits for those who need them the most, while paring back benefits to the well-off.

- A means test is preferable to changing the benefit structure itself. A change in the Social Security benefit formula would not distinguish between a recipient living on their Social Security check alone and those with generous pensions from their employers.

- We can no longer afford to give generous benefits to those who don't need them. Under this option, we can retain the present structure of a program that serves the poor to middle-income well without massive, experimental restructuring.

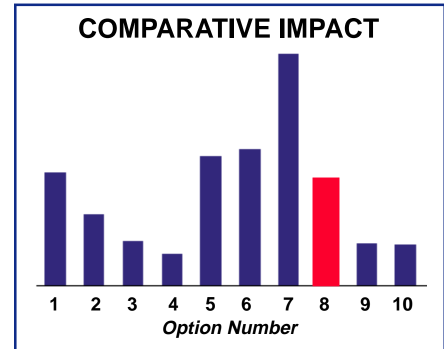
OPPONENTS SAY:

- This punishes those with the foresight to plan ahead and save money for retirement. A proposal that reduces personal savings at the same time that it reduces the deficit is at cross purposes.

- Reducing entitlement benefits to those with higher income will lead to Social Security being seen primarily as a welfare program which would lose political support. Its universality, as a social insurance program that protects all Americans, is why it is so popular. Everyone pays in, so everyone should get the benefits.

- An income test would be difficult to administer effectively and would leave the door open to fraud and gaming the system.

8. Reduce Cost–of–Living Adjustments Based on the Consumer Price Index



CURRENT LAW: Cost-of-Living Adjustments (COLAs) are used in Social Security, the federal income tax code, and other programs to ensure that specified dollar amounts are adjusted every year for inflation, as measured by the Consumer Price Index (CPI).

OPTION: Set all cost-of-living adjustments to CPI minus 0.5%.

BACKGROUND: The Consumer Price Index (CPI) is a measurement of inflation designed to indicate the change in prices of consumer goods. The government surveys the prices of sample products on a regular basis, then averages the measured price changes in a certain proportion known as the fixed market basket. The fixed market basket is based on surveys of consumer spending on categories of items. If 1.3% of consumer purchases was spent on fresh fruit, the price change measured for fresh fruit would be given a weight of 1.3% in the total calculation, and so forth.

There has been substantial debate about how accurately the CPI measures the true cost of living. A recent commission estimated that the CPI overstates it by 1.1 percentage points. There are many sources of bias, some very technical. For example, the particular market basket used can rapidly become out of date. The basket based on surveys taken between 1982 and 1984 was still in use through 1997. This means, for one, that new products can be ignored completely. Two, the calculation does not take into account changes in spending patterns. If the price for apples goes up, people might buy more oranges instead, thereby saving money and reducing experienced inflation. Another example is quality adjustments. If the price of shoes doubles, but they last twice as long as the previous model, there is no true increase in cost, even though their durability is difficult to measure by survey takers. Analysts believe that methodology insufficiently accounts for these differences. The vast majority of economists believe that the CPI is overstated, though most think that the magnitude is less than 1.1 percentage points. But Federal Reserve Chairman Alan Greenspan and some others believe that the bias may be even greater. The government has made some improvements to the CPI, but is unlikely to be able to address all sources of bias.

Why does all of this matter? In 1972, Congress introduced automatic cost-of-living-adjustments (COLAs) for Social Security which would automatically increase benefit checks every year by the rate of inflation, as measured by CPI. Plus, as a response to "bracket creep" in the late 1970s—which caused people to pay a higher tax rate when inflation pushed them into higher tax brackets—Congress passed similar adjustments for tax brackets and related factors.

PROPONENTS SAY:

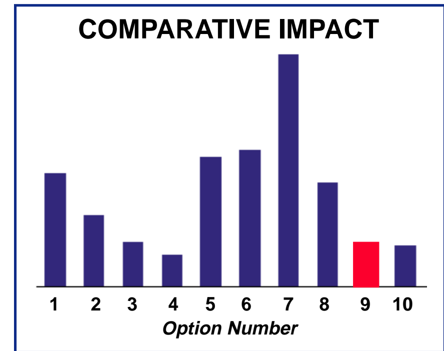
- Automatic indexing provisions were added to protect against increases in the cost of living. The Consumer Price Index is only a basic measure of price inflation. In fact, studies show changes in the CPI to be higher than the actual rise in the cost of living.
- There are many biases in the Consumer Price Index that cannot logistically be fixed within the structure of the CPI itself, so adjustments should be made to compensate for these flaws.
- We are living in an era of constant technological advance that improves the quality of life and decreases the cost of living far beyond what the CPI can measure.
- This proposal goes a long way toward making Social Security sustainable and keeping the budget in balance by asking for a little sacrifice from a lot of people.

OPPONENTS SAY:

- The Consumer Price Index isn't perfect, but it is the best measurement of the cost of living there is. Any adjustments in the measurement of inflation should be made by the professionals and experts in charge of it who can study the issue without a political agenda.
- Legislating an adjustment in cost-of-living increases goes against the purpose of automatic inflation adjustments, which were enacted to take the politics out of Social Security benefit increases.
- This change would have a disproportionate effect on poor Social Security recipients who need their full COLAs to keep from slipping back into poverty.
- This proposal would permanently adjust the method of indexing used in the tax code and represents a back-door tax increase.

9. Reduce Social Security Benefits Across the Board for Future Retirees

CURRENT LAW: The determination of a retiree's initial Social Security benefit check is based on the calculation of Averaged Indexed Monthly Earnings (AIME). The amount of money earned by an individual each year of work is multiplied by the increase in average wages that has occurred in the country up to the year of eligibility for Social Security, and then the average of the highest 35 years (fewer for those receiving disability benefits) of indexed wages is taken and divided by 12 to get the AIME. Once the AIME is calculated, the Primary Insurance Amount (PIA) is determined by applying the "primary insurance amount formula." *(See Social Security Terms and Concepts on page 32 for more information.)*



OPTION: Retain the existing Social Security system but phase in a 5% reduction in primary benefits across the board by 0.5 percent per year for 10 years beginning in 2020.

BACKGROUND: This current formula has been in place since 1977. Before then, wage history was not indexed, and benefits were based on a complicated formula adjusted only by legislation every few years. Ten changes in benefits were made between 1950 and 1974, including a 77% increase in 1950, with a median increase of 13%. Since 1974, automatic cost-of-living adjustments (COLAs) have been given every year based on the rate of inflation.

An average worker retiring at age 65 in 1997 gets $11,200 in benefits. People who had earned at least the maximum covered wage (see option 2) throughout their working lives get about $16,000. Measured in terms of "replacement rates," these benefits would constitute 44% and 25% of their past earnings, respectively. Benefits rise at about the rate of average wages, so the benefit for an average worker retiring at 65 in 2030 will have risen to about $12,300 (in constant 1997 dollars) and the maximum benefit will be about $19,800, but they would represent replacement rates of 37% and 24%, respectively.

Those who earned below-average wages would receive a smaller Social Security check, but it would represent a higher percentage of their past earnings. For example, those who had earned 45% of the average wage would get $6,800 in benefits, but this would amount to a 58% replacement rate.

PROPONENTS SAY:

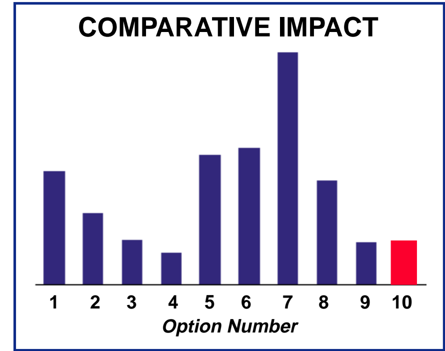
- We have overpromised the amount of benefits we can afford to pay. In the past, when projections were sunny, we increased benefits. Now, with gloomy projections, we should reduce them.
- An across-the-board reduction would treat all beneficiaries equally, rather than singling out a particular group of beneficiaries like a retirement age increase or a means-test would.
- A large part of the Social Security problem is the size of the baby boom generation. That generation should be affected the most by benefit reductions.
- Real benefits, adjusted for inflation, will grow under the current system. Working age Americans should not be burdened by paying for such an increase.

OPPONENTS SAY:

- Social Security is already insufficient to live on now for many poor recipients. We should not reduce their benefits further.
- Even under current law future retirees will be getting back in Social Security benefits a smaller amount relative to what they paid in payroll taxes than previous generations. This would take what is already a bad deal for today's young workers today and make it worse.
- Other structural adjustments, like increasing the retirement age, should be considered before benefit cuts.
- It is important to keep Social Security benefits rising as the nation as a whole gets richer, so that elderly people will be able to share in the benefits of higher living standards.

10. Increase Number of Years Used in Social Security Benefit Computation

CURRENT LAW: The amount of each beneficiary's Social Security check is based on wages earned while he or she was at work. The 35 highest years of earnings (after adjusting for inflation plus real average wage growth) are averaged and then applied to a formula to determine the benefit level.



Wages earned in excess of the cap on payroll taxes for any given year are ignored, as are any wages earned in years which were not among the 35 highest years of earnings for an individual.

OPTION: Increase the number of years of wages used in benefit computation from 35 to 38 or 40, phased in fully for retirees becoming eligible for Social Security in 2003. This would reduce benefits slightly by including three or five additional years of lower earnings in the calculation, thus lowering the average lifetime wage that is applied to the benefit formula. One compromise proposal would increase the number of years to 40 but would remove the wage base cap in the calculation.

BACKGROUND: Social Security benefits are based on the average of the highest 35 years of wages from a beneficiary's working life. An average working life, for example, is considered to be the 40 years between age 22 and 61, inclusive.

Averaging only 35 years allows for five "drop-out" years. This accommodates years of unemployment, low earnings, time off for family concerns or other reasons without lowering future Social Security benefits.

However, if workers are going to live longer and healthier lives, it may be reasonable to expect more years of work in order to qualify for full benefits.

PROPONENTS SAY:

- The currently-planned increase in retirement age implicitly assumes people will be working longer. Therefore, the benefit calculation should reflect this.
- This change would make Social Security benefits more reflective of what is paid into the system during a person's working life. It is entirely appropriate for all wages to count in the calculation to which the payroll tax applies.
- This change would remove an incentive to retire early and so encourages people who can work longer to do so.

OPPONENTS SAY:

- Women are more likely to be hurt by this proposal because they are more likely to take years off from working to meet family responsibilities.
- There are many reasons why some people cannot work a full 38 or 40 years, such as extra time for education or job training. Others work in jobs that require early retirement because of the physical or other stress. A program that is designed to help every American in retirement should take into account that not everyone can conform to these expectations.
- This would penalize people in careers with frequent periods of unemployment.

Private Accounts Phased–In to Replace Current System

CURRENT LAW: Social Security is a federally run, tax-and-transfer social insurance and income replacement system. Workers and employers pay a wage tax at a flat rate, from which the government pays benefits to current retirees. Upon retirement or disability, benefits are calculated using a progressive formula based on past wages, replacing a higher percentage of low-income workers' wages while giving a larger total benefit to those who contributed more. Social Security also provides benefits to spouses with little or no work history, and to survivors.

OPTION: Phase out most Social Security benefits, ultimately funding most of a person's retirement through personal savings. Most proposals leave disability benefits intact as well as benefits for non-elderly survivors, though some require purchasing private life and/or disability insurance. To pay for full benefits to current retirees, the cost of any transition to a new system would reach several trillions of dollars to provide for benefits of at least the current level. The cost can be met by increased tax rates or contribution levels, issuing more federal debt, large cuts in other spending, or a combination of the three. No plan proposes changing current retirees' benefits to any large degree. Most include varying levels of restriction on the types of investments allowed for individual accounts to reduce risk. Most either supplement the savings of low-wage workers and/or provide a minimum benefit to retirees with insufficient retirement accounts.

BACKGROUND: Faced with doubts about the viability of Social Security, some have advocated a system based on personally owned accounts to replace government-run Social Security. Social Security benefits aren't very generous, and saving the current system is likely to require further benefit cuts and/or tax hikes. One alternative is a system where instead of paying taxes to the government, workers would take the same amount of money and invest it for their own retirement, keeping control over their own accounts and not worrying about whether Social Security will still be there upon retirement.

There are drawbacks, of course. Because Social Security is largely a pay-as-you-go system, payroll taxes cannot simply be replaced with private contributions without coming up with the money to pay for current recipients' benefits. Moreover, estimates of future benefits from private savings are inherently uncertain. If the stock market does not perform up to expectations, many more people could become losers with the new system. No longer would everyone be contributing to a single, collective pension system that provides retirement income to everyone and protects against poverty. Many people are more comfortable with a government guarantee of benefits than having to deal with managing retirement funds on their own. Lastly, many years of compounded earnings are needed to build up sufficient retirement assets, and for the baby boom generation, there simply is not enough time before they retire.

PLANS HAVE BEEN DEVELOPED BY: Rep. John Porter (R-Ill.), Rep. Mark Sanford Jr. (R-S.C.), Rep. Nick Smith (R-Mich.), David Altig and Jagadeesh Gokhale, Marshall Carter and William Shipman, Lawrence Kotlikoff and Jeffrey Sachs, and the National Taxpayers Union.

PROPONENTS SAY:

- The increase in personal savings, currently at a low level, would lead to more investment which would fuel economic growth. The current system relies on growth to pay benefits; this would help create it.
- Stock investment would provide people of all incomes, on average, far more retirement income than they would get from Social Security, especially given the reduced benefits needed to fix the current system.
- In the 1930s, people trusted the government to help them more than the private sector. Now, it's just the opposite. If we were designing Social Security today, it would be a system based on savings.

OPPONENTS SAY:

- Social Security has significantly reduced poverty among the elderly, now below all other age groups. In combining social insurance with progressive income redistribution, Social Security provides a unique contribution to society which should not be set aside.
- Many poor people could end up worse off, especially if they retire after a market downturn or exhaust their savings. This would not give them as secure a retirement as Social Security.
- Administrative costs and fees to financial companies would severely cut into people's retirement savings.

Carve–Out Plans

CURRENT LAW: Workers and employers pay a combined 12.4% payroll tax on all wages up to a cap that increases with average wages ($68,400 in 1998). Approximately 90% of all Social Security tax income is spent on current beneficiaries; the remainder is "invested" in special federal bonds to increase the trust fund balance, to be drawn down in a few decades as the baby boomers retire.

OPTION: Reduce the payroll tax by one or two percentage points and require the difference to be deposited in individual accounts, roughly eliminating the current Social Security surplus. Because of the loss of revenue to the federal government, this option would require more benefit cuts or other reforms than necessary to simply bring Social Security spending in line with current revenue, but it would not lead to phasing out benefits altogether. A few proposals would go even further, carving out roughly half of the payroll tax and converting the basic benefit formula into a flat benefit or supplement. This could require some transition financing, similar to what is described under the "Phase-Out" section but to a lesser degree. As before, plans include varying degrees of restriction on the types of investments allowed for individual accounts to reduce risk, with some plans allowing a very limited set of options.

BACKGROUND: What some call "privatization" of Social Security in fact encompasses a wide range of possibilities. Because of the turmoil and transition problems that would result from a full-scale phase-out of Social Security, many have suggested keeping the broad structure of Social Security intact while diverting part of the Social Security tax into individual accounts in return for lowered benefit levels.

In doing so, such reform options would retain Social Security's social insurance role with a degree of progressivity similar to that under the present system. Options in this category have been proposed by many in the political arena as a compromise between a full-scale phase-out and the status quo.

PLANS HAVE BEEN DEVELOPED BY: Sen. Judd Gregg (R-N.H.), Sen. Robert Kerrey (D-Neb.), Sen. Daniel Patrick Moynihan (D-N.Y.), Martin Feldstein, Sylvester J. Schieber and Carolyn L. Weaver, Center for Strategic and International Studies, and Economic Security 2000.

PROPONENTS SAY:

• We should retain the parts of the system which have served us well—protection against poverty and disability. But a 21st century Social Security should do more to help people accumulate real wealth which can build up over the years and can be passed on to their kids when they die.

• Social Security has worked well in the past, but we need to give people more opportunity to save and to provide them with a better retirement income than what a government program alone could provide while simultaneously strengthening the economy.

• England successfully replaced government pensions with a system like this two decades ago. We can do just as well here.

OPPONENTS SAY:

• Carving out some tax money forces unacceptable cuts in basic Social Security benefits to make room for private accounts. We should preserve Social Security's benefit guarantee, not undermine it.

• Any gain from private investments, especially for the poor, are offset by the administrative costs of maintaining individual accounts that contain fairly small amounts of money.

• Social Security is designed to complement private savings and pensions. Now that most pensions (like 401(k)'s) and personal savings provide benefits based on success of investment, it is important to keep a sizeable "defined benefit" system as a base guarantee to protect against poor investments and high inflation.

Add–On Plans

CURRENT LAW: The federal government has a variety of methods to encourage and subsidize individual savings, such as rules for IRAs. However, they are separate from Social Security and all of them are entirely voluntary.

OPTION: Create mandatory individually owned accounts for all workers eligible for Social Security, financed by an increase in payroll contributions. Plans that call for an add-on include other benefit cuts to bring future spending in line with current-law tax revenue. The new individual accounts would provide additional retirement income to make up for reduced benefits under a solvent defined benefit system. Investments would be made in a limited choice of relatively low risk index funds of stocks and bonds managed by the federal government.

BACKGROUND: This option would retain the basic structure of the existing Social Security system but require additional private savings to supplement it. This approach would reinforce the notion that Social Security benefits should not be the sole source of retirement income.

Increasing national savings is a vital component in increased economic growth in the future. National savings has dropped significantly over the past few decades, from 12.3% in the 1960s to about 5% in the 1990s. Mandating personal savings through Social Security would satisfy two public policy goals: increasing national savings and improving retirement income.

On the other hand, requiring people to save more means requiring them to consume less in the short run, so the savings mandate is likely to be perceived as a form of tax.

PLANS HAVE BEEN DEVELOPED BY: Sen. William V. Roth Jr. (R-Del.), Rep. John Kasich (R-Ohio), Edward M. Gramlich, and Committee for Economic Development.

PROPONENTS SAY:

- This is the only savings-based option that provides for an immediate increase in national savings. Other individual account plans do not change national savings in the short term since any deposits in individual accounts are offset by government deficits and the added borrowing that results from diverted revenue.
- Restrictions on investment options saves significant money in administrative costs and ensures that retirees can finance adequate retirements with the money they have saved.
- This is the only way to introduce private savings to Social Security without adding to the deficit or requiring large transition financing. It also avoids making larger benefit cuts than would be required without private accounts.

OPPONENTS SAY:

- Adding mandatory savings is unnecessary. Even if benefit cuts are necessary, don't overcomplicate the system and risk losing public support for it. Savings should remain an individual, voluntary decision.
- This would be especially burdensome on the poor who will not be able to afford additional contributions. It would be better to carve out the contributions from existing taxes.
- The basic Social Security system would remain a poor deal for younger workers. A more radical restructuring plan is necessary to provide for adequate retirement income.

Social Security Terms and Concepts

Adjusted gross income (AGI): Amount of income potentially subject to Federal income taxation, before consideration of exemptions and deductions.

Average indexed monthly earnings (AIME): The amount of earnings used in determining the primary insurance amount (PIA) for most workers who attain age 62, become disabled, or die after 1978. A worker's actual past earnings are adjusted by changes in the "average wage index," in order to bring them up to their approximately equivalent value at the time of retirement or other eligibility for benefits.

Average wage index: The average amount of total wages for each year after 1950, including wages in non-covered employment and wages in covered employment in excess of the OASDI contribution and benefit base. These amounts are used to index the earnings of most workers first becoming eligible for benefits in 1979 or later, and for automatic adjustments in the contribution and benefit base, bend points, earnings test exempt amounts, and other wage-indexed amounts.

Bend points: The dollar amounts defining the AIME or PIA brackets in the benefit formulas. The bend points are the dividers in the progressive formula in which the PIA replaces a larger proportion of pre-retirement earnings for people with lower average earnings than for those with higher earnings. See PIA formula definition below for more information.

Federal Insurance Contributions Act (FICA): Provision authorizing taxes on the wages of employed persons to provide Retirement, Survivors, and Disability Insurance, and for Hospital Insurance. The tax is paid in equal amounts by workers and their employers.

Normal retirement age: The age at which a person may first become entitled to unreduced retirement benefits. Currently at age 65, but scheduled under present law to increase gradually to 67 for persons reaching that age in 2027 or later, beginning with an increase to 65 years and 2 months for persons reaching age 65 in 2003.

Pay-as-you-go financing: A financing scheme where taxes are scheduled to produce just as much income as required to pay current benefits, with trust fund assets built up only to the extent needed to prevent exhaustion of the fund by random economic fluctuations.

Primary insurance amount (PIA): The monthly amount payable to a retired worker who begins to receive benefits at normal retirement age or (generally) to a disabled worker. This amount, which is related to the worker's average monthly wage or average indexed monthly earnings (AIME), is also the amount used as a base for computing all types of benefits payable on the basis of one individual's earnings record.

Primary insurance amount (PIA) formula: The mathematical formula relating the PIA to the AIME for workers who attain age 62, become disabled, or die after 1978. The PIA is equal to the sum of 90 percent of the AIME up to the first bend point, plus 32 percent of AIME above the first bend point up to the second bend point, plus 15 percent of AIME in excess of the second bend point. Automatic benefit increases are applied beginning with the year of eligibility. In 1998, the formula is: 90 percent of the first $477 of AIME, plus 32 percent of AIME in excess of $477 but not in excess of $2,875, plus 15 percent of AIME in excess of $2,875.

Self-Employment Contributions Act (SECA): Provision authorizing Social Security taxes on the net earnings of most self-employed persons.

Social Security Act: Provisions of the law governing most operations of the Social Security program. Original Social Security Act is Public Law 74-271, enacted August 14, 1935. With subsequent amendments, the Social Security Act consists of 20 titles, of which four have been repealed.

Taxable earnings: Wages and/or self-employment income, in employment covered by the OASDI (Social Security) and/or HI (Medicare Part A) programs, that is under the applicable annual maximum taxable limit. The maximum taxable limit for Social Security is $68,400 in 1998. For 1994 and later, no maximum taxable limit applies to the HI program.

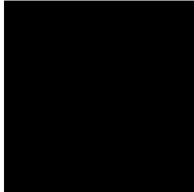
Taxable payroll: A weighted average of taxable wages and taxable self-employment income. When multiplied by the combined employee-employer tax rate, it yields the total amount of taxes incurred by employees, employers, and the self-employed for work during the period.

SOURCES: Social Security Trustees Report (1998), Congressional Budget Office.

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 a co-chair of The Concord Coalition in April 1997.

Co-Chairmen



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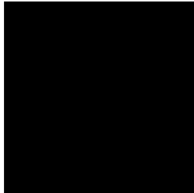
Former United States Senator
(R-N.H.)



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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.*