IV. BACKGROUND INFORMATION FOR DISCUSSING THE FUTURE OF SOCIAL SECURITY

Proposals to Address the Long-Range Solvency Problem and Their Impact

Many ways have been suggested for addressing the future financing needs of Social Security. They include changes in revenues as well as in benefits. Most of the comprehensive proposals that have been made have included a combination of the two. In addition, there have been a number of different proposals to restructure the Social Security system by creating either mandatory or voluntary individual investment accounts. These accounts would supplement or replace part or all of the present Social Security system.

According to the actuarial estimates in the 2001 report of Social Security’s Board of Trustees, the program faces a long-range shortfall in funding of 1.86 percent of payroll over the 75-year estimating period, equivalent to about $3.4 trillion in 2001 (present value). In other words, if the shortfall were to be met only by raising taxes, workers and their employers would each have to contribute about 1.0 percent of taxable wages throughout the period. This would be in addition to the 6.2 percent that each is currently paying. Future additional increases in taxes would be required to assure the program’s solvency beyond the 75-year time frame.

Whatever changes are ultimately agreed upon, over the long term projected revenues will have to match projected spending if solvency is to be assured. Examples of ways to address the solvency issue are described below. The estimates of the impact of the changes were provided by the Social Security actuaries and show the impact of each change as a percentage reduction in the estimated shortfall in funding that exists under current law (current law tax rates and benefit levels). Effects of individual changes are not necessarily additive — if adopted as part of a reform package, they could have interactive effects.

- **Reduce the Social Security cost-of-living adjustment (COLA).** Each year Social Security benefits are increased to reflect increases in the Consumer Price Index (CPI). Many experts believe that the CPI overstates inflation. The total size of the overstatement is a subject of dispute. In order to address one source of overstatement the Bureau of Labor Statistics (BLS) is currently developing a “superlative” CPI which will be retroactively updated on the basis of more complete survey data and will measure substitution of consumption items. According to BLS, it is expected to produce, on average, a slightly lower measure of price increases than the measure that is currently used to adjust Social Security benefits.

  A reduction in the cost-of-living increase of 1 percentage point below the CPI beginning in 2002 would eliminate about 77 percent of the long-range deficit. A reduction of 0.5 percentage point would eliminate 40 percent.

  These changes in the COLA would reduce cost-of-living increases for all individuals who receive benefits after the changes are effective, including both current and future beneficiaries. Because

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the changes would be cumulative, their effect would grow over time. The impact would increase as people live longer. For example, a 1 percentage point COLA reduction would reduce a retired worker’s benefits below levels provided in current law by about 12 percent when the worker is age 75 and by about 20 percent at age 85.

- **Increase the number of years used in calculating Social Security retirement and survivors benefits.** At the present time benefits are calculated based on a worker’s highest 35 years of earnings. A gradual increase of three years (from 35 to 38) would eliminate 14 percent of the deficit. An increase to 40 years would eliminate 22 percent.

  An increase to 38 years would reduce benefits about 3 percent on average. Workers with fewer years of earnings than the average (including women who may have care-giving years outside of the paid workforce) would likely have a greater reduction. This proposal would affect workers who become eligible for benefits after the change is effective.

- **Modify the formula used to calculate initial benefits to reduce benefits across the board.** An immediate across-the-board benefit reduction of 3 percent would eliminate 20 percent of the deficit. A reduction of 5 percent would eliminate 33 percent. This proposal would reduce benefits for individuals who become eligible for benefits after the change becomes effective.

- **Speed up the increase in the “normal retirement age” that will occur under present law; increase it beyond age 67.** Present law provides for phasing in an increase in the normal retirement age from the current age 65, reaching 67 for those who turn that age in 2027. Speeding up this increase so that it is fully in effect for those who turn age 67 in 2016 would eliminate 8 percent of the deficit. Further increasing the age to 68 by indexing at a rate of 1 month every 2 years, reaching 68 for those who turn that age in 2041 (in addition to speeding up the increase to age 67) would eliminate 23 percent of the deficit. A further increase by indexing to age 70 would eliminate 32 percent. Increasing the normal retirement age has the effect of reducing the level of benefits for future beneficiaries.

- **Reduce or eliminate benefits for workers with higher incomes.** The amount of savings from this change would depend on the level at which the income restrictions are applied. For example, reducing benefits by 10 percent beginning at a family income of $40,000 annually and an additional 10 percent for each $10,000 of income up to a maximum of 85 percent would eliminate 89 percent of the deficit. Another alternative would be to limit future cost-of-living increases for individuals with higher income.

  These kinds of changes would introduce a “means test” for Social Security beneficiaries. It would apply to all benefits payable after the effective date of the change, including both current and future beneficiaries. It would reduce the rate of return that higher income beneficiaries receive on their Social Security taxes.

- **Raise Social Security payroll tax rates.** An increase from the current 12.4 percent of taxable earnings (6.2 percent each for workers and their employers) to 14.4 percent in 2002 would eliminate the 75-year actuarial deficit. An increase in the tax rate to 14.8 percent in 2020 with an additional increase of 2.4 percent in 2050 would also eliminate the deficit. Increasing payroll tax rates would not affect those already retired and receiving benefits and would have a limited effect on those close to retirement. It would have the greatest effect on young workers and those not yet in the workforce who would pay increased taxes over most or all of their working lifetime. All employers of covered workers would also contribute.
• **Increase the portion of Social Security benefits that is subject to the income tax.** Under present law, Social Security benefits are taxable only if income is above specified thresholds. One alternative would be to phase out the thresholds and tax benefits in a manner similar to that for contributory private pension income, that is, tax benefits to the extent they are expected to exceed what the worker paid in taxes. Phasing out the lower thresholds during 2002-2011, taxing benefits similar to private pensions, and putting all additional revenue raised into the Social Security Trust Funds would eliminate 24 percent of the deficit.

Most beneficiaries would pay increased income taxes. However, because the income tax is structured to protect low income people from being required to pay taxes, beneficiaries with low income would still not pay any income tax on their benefits.

• **Increase the amount of earnings subject to the Social Security tax.** In 2001, earnings in employment covered by Social Security that exceed $80,400 are neither subject to payroll tax nor considered for calculating benefits. This “contribution and benefit base” increases automatically each year with increases in the average wage. Currently, about 84 percent of all covered earnings are below the base, but this percentage has been falling from about 90 percent in 1983 and is projected to continue to fall to about 83 percent in 2010.

Making all earnings covered by Social Security subject to the payroll tax beginning in 2002, but retaining the current law limit for benefit computations (in effect removing the link between earnings and benefits at higher earnings levels), would eliminate the deficit. If benefits were to be paid on the additional earnings, 88 percent of the deficit would be eliminated.

Making 90 percent of earnings covered by Social Security subject to the payroll tax and paying benefits on the additional earnings (phasing in these increases in 2002-2011) would eliminate 37 percent of the deficit. This would increase the estimated maximum amount of earnings subject to Social Security taxes in 2011 to $241,200, compared to the projected level of $125,100 under present law (in current dollars). These changes would cause higher-paid workers and their employers to pay higher taxes. They would mean that higher-paid workers (those above the current taxable maximum) would receive a lower average rate of return on their Social Security taxes than they do today.

• **Extend Social Security coverage to all new employees of State and local governments.** Social Security coverage is virtually universal, with the largest excluded group being employees of a number of State and local governments (those employees who are covered by their own pension system). About 30 percent of State and local government employees are not now covered by Social Security. A proposal to cover non-student State and local employees hired after January 1, 2002, would eliminate 11 percent of the deficit. The impact of this change would fall on those State and local governments whose employees are currently outside the Social Security system and on all individuals hired by these entities after the effective date of the change.

• **Invest Social Security reserves in the stock market.** The impact on the long-range deficit would depend on the rate of return on stocks relative to Treasury bonds. The real interest rate on long-term bonds is projected by the actuaries to be about 3.0 percent. By comparison, over the period 1900 to 2000, the real return on investments in stocks has been about 7 percent. If in the future the return on stocks were 4.0 percentage points higher than the rate of return for Treasury bonds, then a 40 percent investment in stocks phased in between 2002 and 2016 would eliminate 55 percent of the deficit. If the return on stocks averages 3.0 percentage points higher than for bonds, then a 40 percent
investment in stocks would eliminate 42 percent of the deficit. This would reduce the need for future benefit cuts or tax increases to maintain the solvency of the program. Questions about the government’s role in managing investments in the stock market would have to be addressed.

- **Use the general revenues of the Treasury to make up the long-range deficit.** A contribution from the general fund of the Treasury to the Social Security Trust Funds could be used to make up all or a portion of the long-term deficit. The use of general revenues would be a departure from the approach historically used in the United States to finance Social Security. Unless there is a surplus in the operating budget of the Federal government, it would require tradeoffs with other government expenditures.

The impact of using money from general revenues (which are derived largely from individual income taxes) to help pay Social Security benefits would fall on both beneficiaries and workers. Because of the progressive nature of the income tax, those with higher incomes would be affected more than those with lower incomes.

- **Require or allow workers to invest a portion of their wages in individually owned private investment accounts.** Moving to a system of individual investment accounts would enable individuals to control how their contributions are invested. The return that each worker realizes would depend on future market trends and the investment choices made by the individual.

Replacing a part or all of Social Security with individual accounts would reduce or eliminate the accumulation of additional benefit obligations under the Social Security program and would provide for pre-funding part or all of retirement benefits for account holders. However, because Social Security must continue to pay benefits to individuals who have already contributed to the current pay-as-you-go system, any transfer of taxes into individual accounts from the Social Security Trust Funds would increase Social Security’s operating deficit during a transition period. Benefit cuts or additional sources of revenue would have to be found to offset the payroll tax revenue diverted to the individual accounts. These changes would be in addition to the benefit cuts or additional sources of revenue necessary to eliminate the previously existing deficit. An alternative would be to establish voluntary or mandatory individual accounts funded by an increase in the payroll tax as a supplement to the existing Social Security system, rather than as a partial or complete replacement.

- **Use unified budget surpluses to provide individual investment accounts.** Using unified budget surpluses to provide individual accounts would enhance retirement income for current workers. By itself it would not reduce the long-range Social Security deficit. If surplus Social Security revenues are “borrowed” in order to provide the accounts, additional sources of revenue would have to be found in the future in order to repay the Trust Funds.

- **Return to pay-as-you-go financing.** Setting payroll tax rates at a level sufficient to pay benefits on a current-cost basis (without accumulating more than a minimal reserve) would eliminate the long-range deficit. In the short run, it would result in a payroll tax reduction of about 2 percentage points (1 percent each for employees and employers). One alternative would be to allow workers to invest the amount by which their taxes are reduced in voluntary individual accounts. In the long term, pay-as-you-go financing would increase payroll taxes for workers and their employers by about 3 percentage points each as of 2075, unless there were offsetting reductions in benefit costs.