

SOCIAL SECURITY:
***WHY ACTION SHOULD
BE TAKEN SOON***

**Social Security Advisory Board
July 2001**

(Revised Edition)

Social Security Facts

What Do Your Social Security Taxes Pay For?

Workers and their employers each pay 6.2 percent on earnings of up to \$80,400 into Social Security. These taxes pay for retirement, disability, family benefits, and survivors benefits. Currently about 154 million workers (96 percent of all jobs) are covered by Social Security, and about 45 million people (one out of every 6 Americans) are receiving benefits.

Social Security Provides:

- Retirement benefits to more than 28 million retired workers. Reduced benefits are payable at age 62; for workers reaching age 62 in 2001, full benefits are payable at 65 and 4 months. (The age at which full benefits are payable will increase gradually to age 67 by 2027.)
- Disability benefits to more than 5 million disabled workers with a severe physical or mental impairment that is expected to prevent them from doing “substantial” work for a year or more or who have a condition that is expected to result in death.
- Family benefits to about 3 million spouses and almost 2 million children of retired and disabled workers.
- Survivors benefits to more than 7 million survivors of deceased workers, including nearly 2 million children.

Since 1972, all Social Security benefits have been indexed to increase automatically with increases in the Consumer Price Index, thus providing protection against inflation.

What Is Social Security’s Current Budget Situation?

- In calendar year 2001, income to the Social Security Trust Funds is projected to be about \$604 billion, and outlays \$439 billion, leaving a surplus in 2001 of over \$165 billion. The total amount of the Trust Funds at the end of 2001 is expected to be approximately \$1.2 trillion, which equals about 34 months of Social Security benefits (including disability benefits).
- Social Security will account for about 24 percent of total Federal government outlays in fiscal year 2001, and 23 percent of total Federal government receipts.
- Fiscal year 2001 projected administrative costs for the Social Security programs are \$3.5 billion — less than 1 percent of total Trust Fund outlays.

Social Security Advisory Board

An independent, bipartisan Board created by Congress and appointed by the President and the Congress to advise the President, the Congress, and the Commissioner of Social Security on matters related to the Social Security and Supplemental Security Income programs.

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I. INTRODUCTION

The Social Security Advisory Board is issuing this report in response to requests from policy makers and others for background information that can be used in the important discussion that is currently taking place regarding the future of Social Security. The content and format are essentially the same as in the Board's report of July 1998, titled *Why Action Should Be Taken Soon*, although the information provided has been updated to reflect the changes in data and assumptions included in the Report of the Social Security Trustees for 2001.

There are many views about the kinds of changes that should be made in the Social Security program. Whatever one's views, essential facts should be agreed upon. The purpose of this paper is to establish two realities that every citizen needs to take account of: (1) the dimensions of the changes that are required if the Social Security system is to maintain solvency beyond 2038, the year the Trust Funds are projected to be exhausted, and (2) the need to make these changes sooner rather than later.

Congress has amended the Social Security law many times since it was enacted in 1935. It has never allowed the program to reach the point where promised benefits could not be paid, and it is unthinkable that it would ever do so in the future. However, delay uses up valuable time, and gives policy makers and the American people fewer and more difficult choices. Prompt action is essential if we are to restore confidence in the future of Social Security and enable today's workers to plan for a secure retirement.

Social Security is a social insurance program to which nearly all workers, along with their employers, are required to contribute in order to provide protection against the risk of loss of wages due to retirement, disability, or death of a worker. Retired workers make up 63 percent of all beneficiaries. But the program's income protection extends beyond retired workers. According to estimates, about 4 out of 10 young men, and 3 out of 10 young women, who are now age 20 will die or become disabled before reaching age 67. Today, 11 percent of all Social Security beneficiaries are workers who are disabled and have not reached retirement age; 11 percent are spouses and children of retired and disabled workers; and 15 percent are spouses and children of deceased workers. Whatever changes are enacted, Social Security must continue to protect these vulnerable individuals.

Prompt action is essential if we are to restore confidence in the future of Social Security and enable today's workers to plan for a secure retirement.

Some think that Social Security should become more of a retirement savings program. They propose that a portion of a worker's earnings be placed in individual investment accounts, either on a mandatory or a voluntary basis. Others believe that the program should be maintained largely as it is now, and that solvency should be maintained without making structural changes. (See page 21 for a brief description of some of the proposals that have been made to address the long-range solvency problem.) All of the proposed changes require tradeoffs. Evaluating the merits will require careful assessment of their impact on the well-being of individuals and of society at large.

In considering changes to Social Security, it will also be necessary to take into account the Medicare program. Over the next few years, legislative changes will have to be made to Medicare if the Hospital Insurance Trust Fund is to remain solvent beyond 2029, the year it is projected to be exhausted. Because Social Security and Medicare serve many of the same individuals, and both are financed largely from payroll taxes, they share the challenge of paying for benefits for an increasing number of older persons at the same time that growth in the workforce is slowing. It will be important for policy makers to consider the impact that changes in one program may have on their ability to assure the long-range solvency of the other.

Finally, it is important to recognize that Social Security is only one part of our multi-pillar retirement income system. Social Security has always been intended to provide a foundation for retirement income that needs to be supplemented by individual savings and employer pensions. All parts of this system are in need of review since Americans as a whole are not making adequate provision for their retirement.

Social Security reform should be meshed with a strengthening of the other parts of the retirement income system, including employer pensions, individual retirement accounts, 401(k) plans, and other saving mechanisms. Considering Social Security reform within this larger context is a vital aspect of the reform process.

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II. THE LOOMING FINANCING SHORTFALL

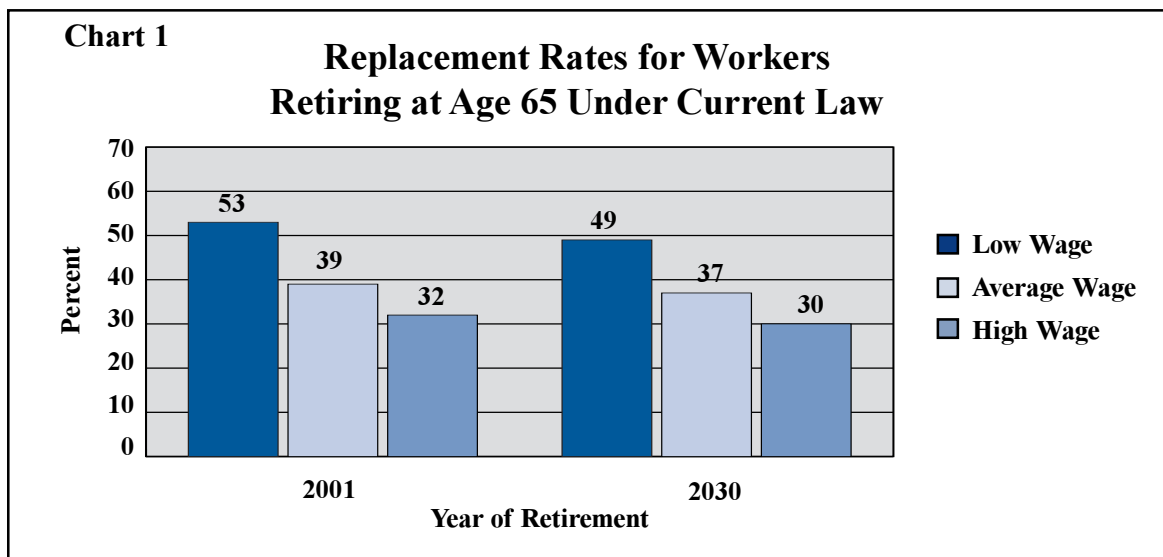
Benefit Levels Under Current Law

In the early years of the Social Security program, benefits were payable only if a worker had reached age 65 and was fully retired. Over the years, the Congress has amended these provisions of law. The Social Security Act now allows individuals to begin to draw reduced benefits as early as age 62. Those who have reached the normal retirement age may receive full benefits regardless of the amount of earnings they receive from employment. The benefits of individuals between age 62 and the normal retirement age who have earnings may be subject to reduction, depending upon the amount of their earnings.

What Retired Workers Receive Now

The portion of a worker's earnings that is replaced by Social Security varies according to the worker's wage level. Low wage workers have a higher portion of their wages replaced than do higher wage workers. Chart 1 shows the portion of wages replaced ("replacement rates") for workers with different earnings levels who retire at age 65 in 2001 and in 2030.

As shown in the chart, the replacement rate for a low-wage earner retiring at age 65 in the year 2001 is about 53 percent, and for a relatively high-wage worker the replacement rate is about 32 percent.



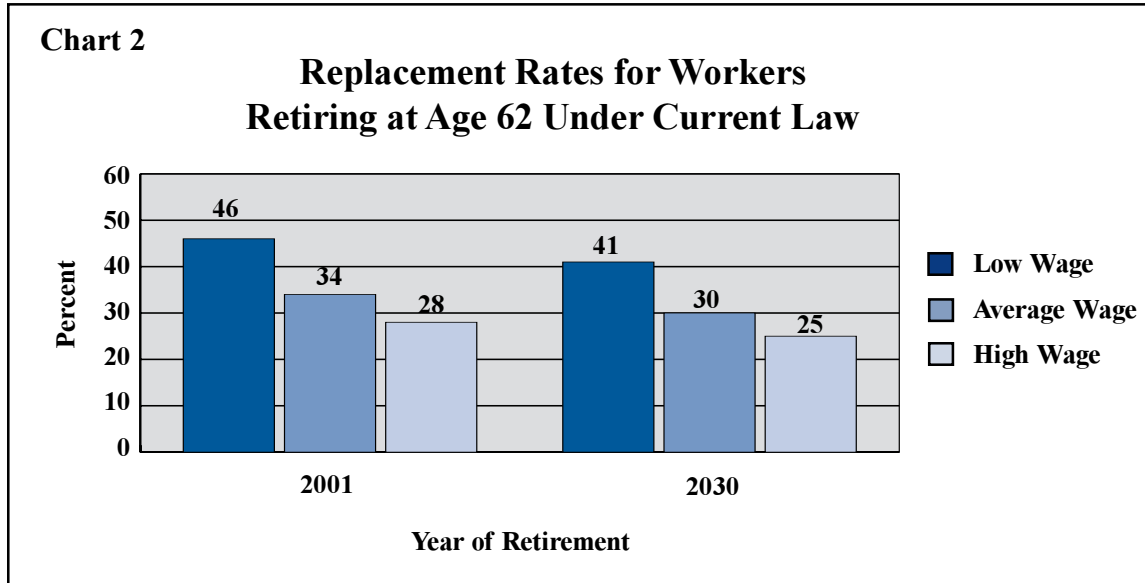
The Effect of the Scheduled Increase in the Retirement Age

As the chart also shows, replacement rates for individuals who retire at age 65 will decline in future years. This decline will occur as a result of a change in the law in 1983, which provided for a gradual increase in the normal retirement age from age 65 to 67. The increase in the normal retirement age began in 2000 and will reach age 67 for those turning that age in 2027.

Although individuals will continue to be eligible for early retirement benefits at age 62, those who elect to receive benefits at that age in the future will have their benefits actuarially reduced by more than early retirees now do. Social Security benefits for early retirees are reduced on what

is termed “an actuarial equivalent” basis, so that total lifetime benefits paid to people over a longer period are made roughly equal to what would have been paid to them had they waited until normal retirement age to receive benefits.

For example, when the increase in the retirement age is fully phased in, people will receive 70 percent of full retirement benefits at age 62, instead of 80 percent, as is the case today. At age 65, people will receive 86.7 percent, rather than 100 percent. The net effect of increasing the



normal retirement age for those who retire before that age is that their benefits will represent a smaller percentage of their prior earnings compared to those who retired in earlier years. However, because life expectancy is increasing, they will get these benefits over what is, on average, a longer lifetime than is typical today.

Although benefits for future retirees will decline as a percentage of their prior wages, the actual dollar amount of benefits and their purchasing power are expected to continue to rise. (See Table 1) The reason is that, on average, “real” wage growth (the amount by which wages are expected to grow relative to prices) is more than enough to offset the reductions in benefits caused by the increase in the retirement age. Future benefits will be based on those higher wages.

Table 1

**Estimated Future Annual Benefits Payable to Workers
Who Retire at Age 65 at Various Earning Levels
(in 2001 dollars)**

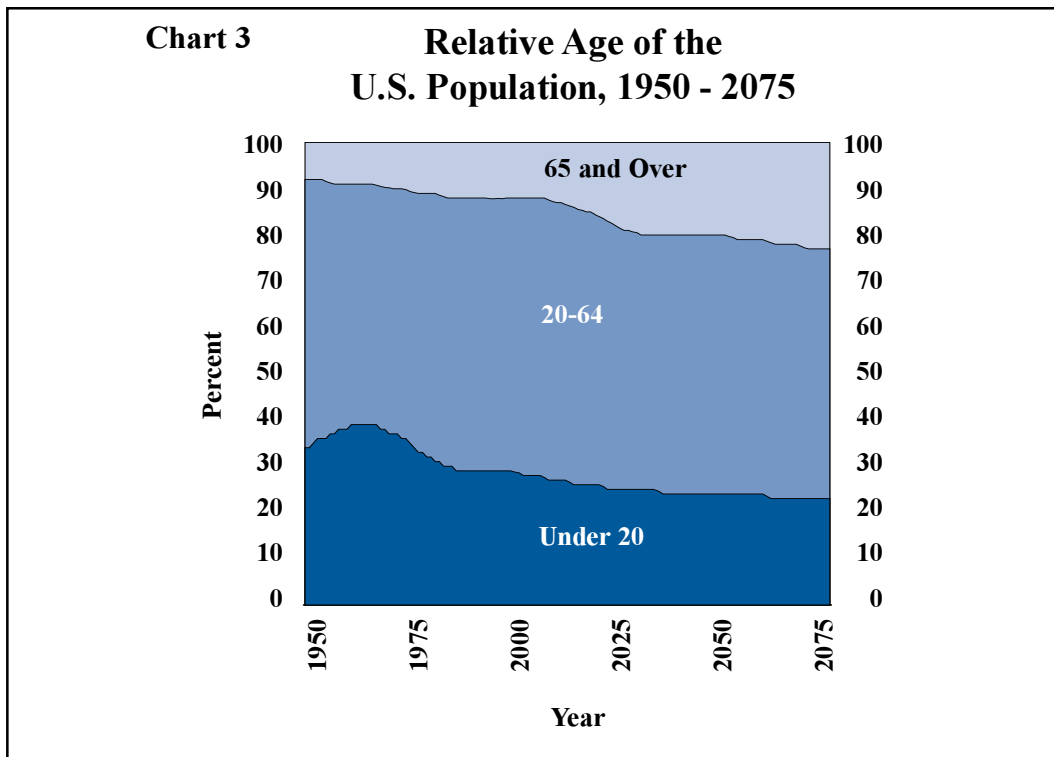
<u>Year</u>	<u>Low Earner</u>	<u>Average Earner</u>	<u>High Earner</u>
2001	\$7,661	\$12,642	\$16,419
2030	\$9,598	\$15,843	\$20,936

What Will Happen When the Baby Boomers Retire?

Although the above replacement rates and benefit levels are what present law calls for, current projections of income and spending for Social Security indicate that there will not be enough money coming into the program to meet future obligations. This is because most of the money used to pay benefits for current retirees comes from the payroll taxes paid by current workers and their employers. The demographic changes that are occurring in the United States mean that in future years there will be more retirees but relatively fewer workers to pay for their benefits.

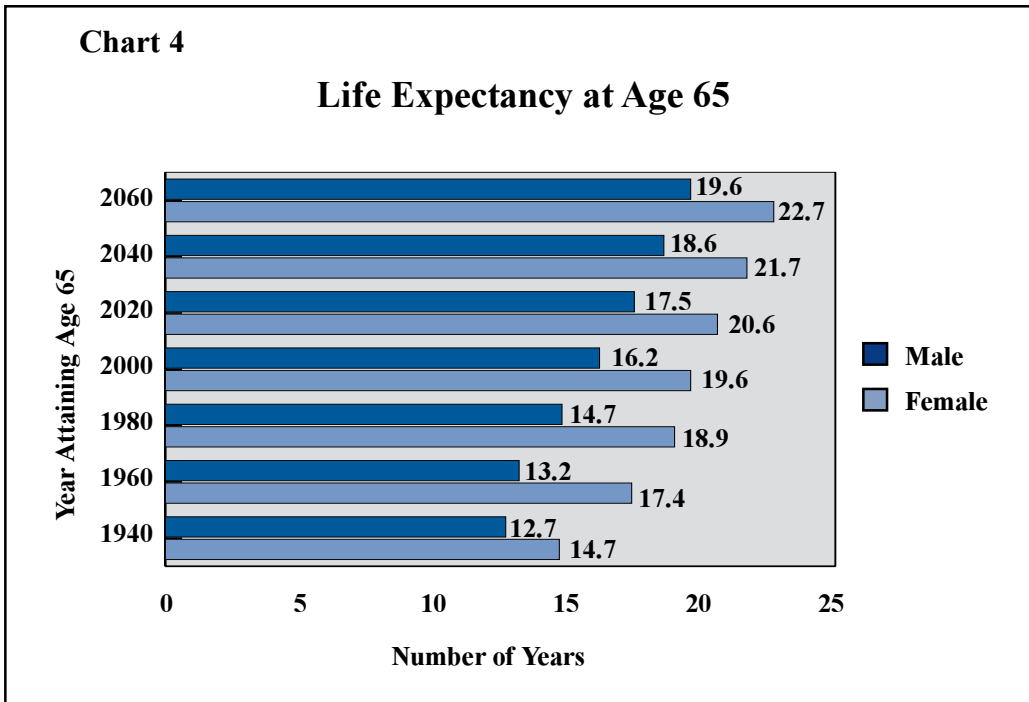
More Retirees

A major shift in the relative size of the working age and elderly populations will begin to occur in the first few years of this century. The large numbers of people born during the post-World War II “baby boom” currently make up most of the workforce paying Social Security taxes. But they are nearing retirement age, and the oldest of the baby boomers (those born in 1946) will reach age 65 in the year 2011. By 2030, about 20 percent of the population is expected to be 65 or over as compared to about 12 percent in 2001. When the baby boomers move from being taxpayers to being beneficiaries, the cost of the Social Security program will rise quickly.



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Another factor contributing to increasing retirement costs is that people are living longer. In 1940, when the first Social Security benefits were paid, a man who reached age 65 could look forward to fewer than 13 years of life, and a woman had a life expectancy of fewer than 15 years. By 2030, when virtually all the boomers will have retired, life expectancy at age 65 is projected to be nearly 18 years for men and more than 21 years for women. Longer lives for retirees mean more years receiving Social Security benefits.



Relatively Fewer Workers

While the growing number of retirees and the increasing duration of retirement will cause spending for Social Security to grow, other factors will cause a slowdown in the growth of the labor force. Projections indicate that the average rate of growth of the labor force will slow from the 2 percent a year it achieved from 1960 through 1989, to 1 percent annually for the years 1990 through 2009, and 0.3 percent for years 2010 through 2050.

The major reason for this slowdown is the decline in the birth rate that began in the 1960s. During the mid- to late-1960s, fertility began to decline dramatically, shrinking from above 3.00 children per woman from 1947 to 1964 to a low of just 1.74 by 1976. Since then, it has

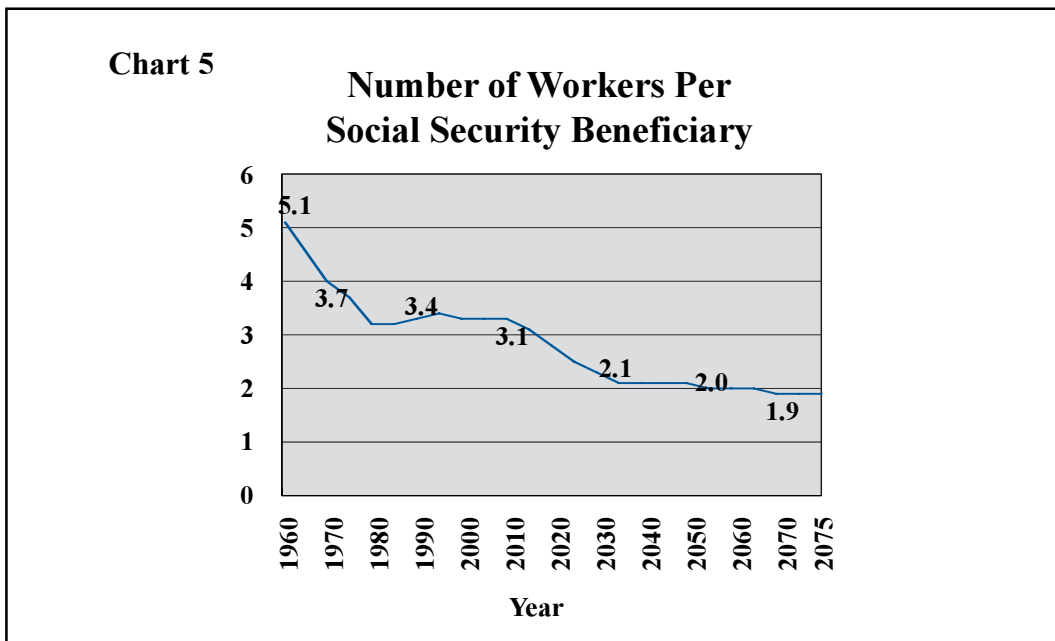
***Another factor contributing to increasing retirement costs is that people are living longer...
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edged up to 2.07. Over the long run, the Social Security actuaries project a total fertility rate of about 1.95. Because of lower birth rates, there will be fewer workers to replace the baby boomers as they retire.

Another reason for the slower growth in the number of workers is that the rapid growth in labor force participation by women is expected to level off. The female labor force participation rate increased from 34 percent in 1950 to 60 percent in 2000. Greater labor force participation among women has offset some of the costs of the growing number of Social Security retirees, but this trend must eventually end. Over the long term, female participation rates are generally expected to increase only slightly above today's level.

Decline in Number of Workers Per Beneficiary

Since most of the money used to pay benefits under the Social Security program comes from the payroll taxes paid by current workers and their employers, the number of workers relative to the number of beneficiaries affects the ability of society to meet obligations to retirees. With more retirees and little growth in the number of workers, the ratio of workers to beneficiaries will decline substantially for several decades. In 2000 there were 3.4 workers for every beneficiary. This ratio will decline to about 2.1 workers per beneficiary in 2030. After the year 2030, this ratio will continue to decline slowly, reflecting the increasing numbers of beneficiaries due to assumed increases in life expectancy.

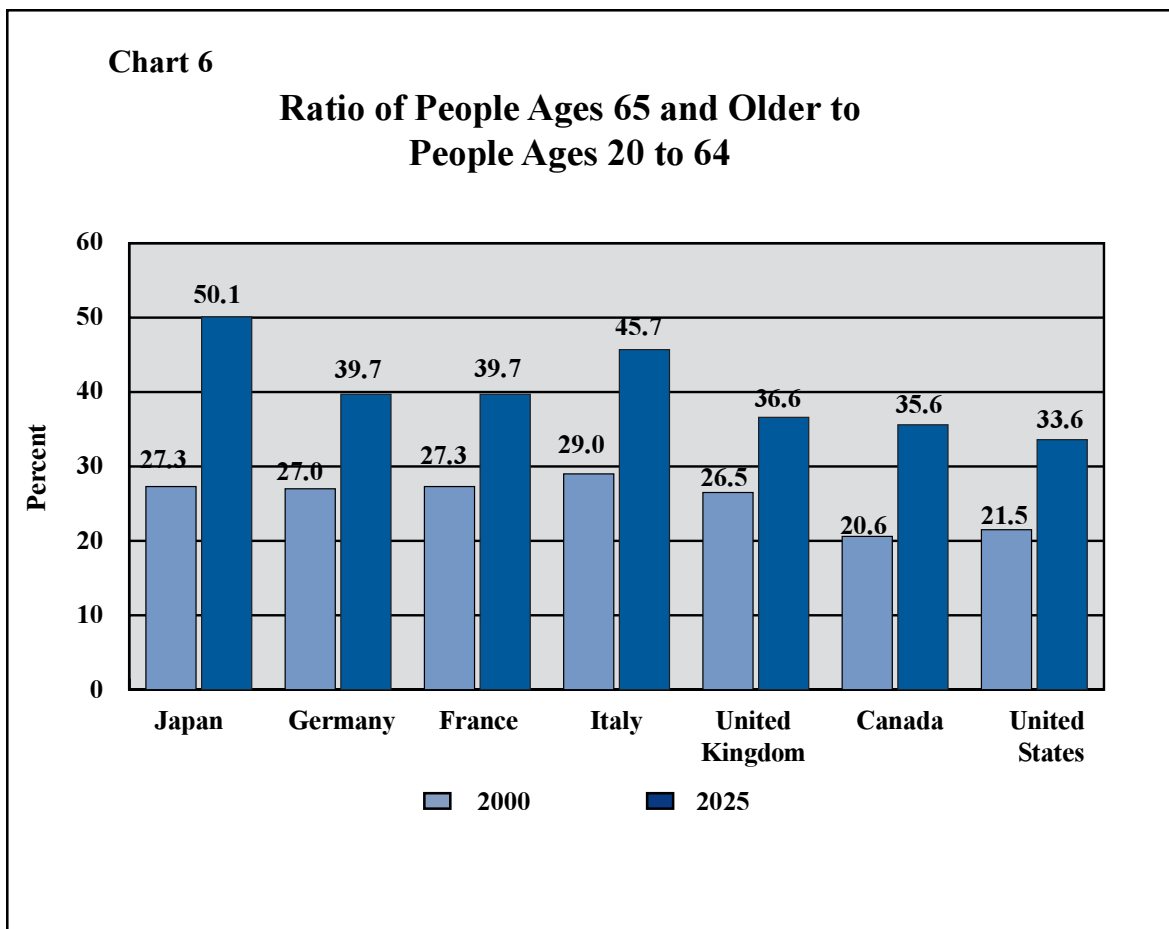


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One of the principal uncertainties for the 21st century is whether the demand for labor in the economy will increase the number of jobs available for older workers and, if so, whether these workers will be willing to postpone retirement and continue to work, on either a full- or part-time basis. To the extent that older workers remain in the labor force and continue to pay into Social Security, some of the anticipated decline in the ratio of workers to beneficiaries that is reflected in Chart 5 would be reduced, and the magnitude of the financing problem would also be reduced.

Experience in Other Countries

The rapid aging of the population over the next few decades is not confined to the United States, but is manifested in countries the world over. In fact, the United States is somewhat better off than other developed countries in this regard. In 2000, in most industrialized countries, the ratio of individuals ages 65 and over to the population ages 20 to 64 ranged from about 21 percent in Canada to 29 percent in Italy. By 2025, according to projections of the U.S. Census Bureau, these ratios will have grown to amounts ranging from nearly 36 percent in Canada to more than 50 percent in Japan. In 2025, the U.S. is expected to have a lower ratio of older individuals to those of working age, under 34 percent, than any other major industrialized country. (See Chart 6)

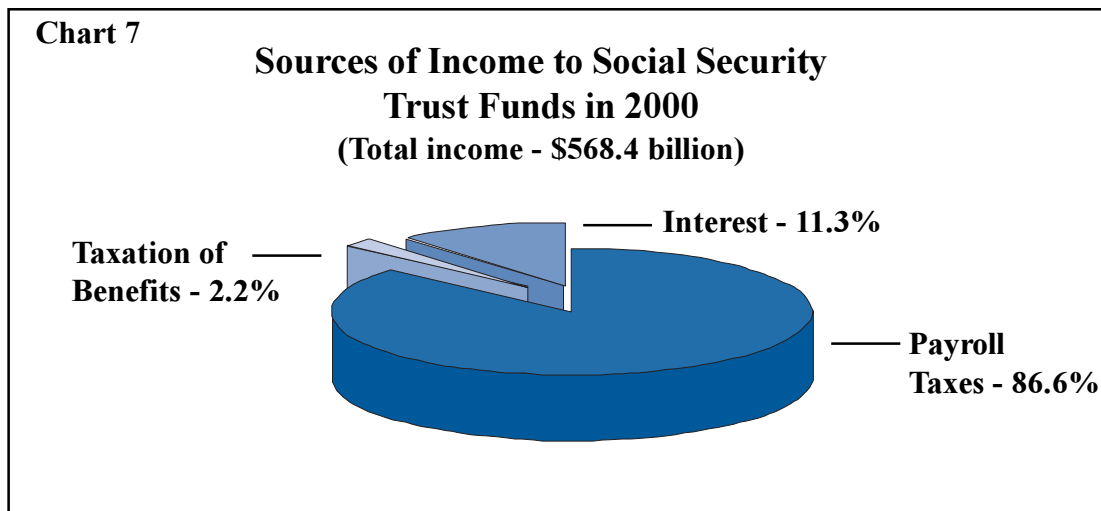


The Status of the Social Security Trust Funds

The Current Situation

In 2000, total income to the Social Security Old-Age, Survivors, and Disability Insurance Trust Funds exceeded spending by more than \$153 billion. The amount of this excess income is expected to increase over the next 13 years, after which it will decline until 2025 when expenditures will exceed income. At the end of 2000, the Trust Funds had assets of about \$1.05 trillion. Assets are expected to grow to \$6.5 trillion in current dollars by 2025. By law, Social Security income that is not needed to pay benefits is invested in U.S. Treasury bonds.

In 2000, payroll taxes accounted for nearly 87 percent of income to Social Security, interest on Trust Fund investments accounted for about 11 percent, and income from taxes on Social Security benefits accounted for about 2 percent. (See Chart 7)



Income from payroll taxes and taxes on benefits is expected to be higher than spending for benefits and administrative expenses until the year 2016. Thus, until 2016 the Social Security program will be a net plus for the Federal budget. This surplus helps to account for the projected surplus in the so-called “unified Federal budget,” which includes the operations of both the general fund of the government and a number of trust funds designated for special purposes, such as the Social Security, Medicare, and Highway Trust Funds. The U.S. Treasury borrows Social Security’s surplus income, uses it for other government purposes (currently for reducing the Federal debt), and issues bonds to the Social Security Trust Funds.

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Spending Will Exceed Taxes in 2016

Beginning in 2016, Social Security expenditures will be higher than tax income. At that time, an amount equal to all of the tax income and a part of the interest due to the Trust Funds on outstanding bonds will be needed to pay the benefits that are due. The Federal government will have to find additional funds elsewhere to meet its obligations to Social Security beneficiaries.

Spending Will Exceed Taxes Plus Interest in 2025

Beginning in 2025, Social Security spending will exceed total Social Security income (taxes plus interest on the bonds). At this point the government will have to begin paying back the funds it has borrowed from Social Security. This will provide the government with a larger public finance issue that will need to be addressed because, in order to pay the benefits that are due, the Treasury will have to redeem the bonds held by the Trust Funds.

By cashing in the bonds, Social Security will be able to pay the full amount of promised benefits until 2038. In that year, all of the assets of the Trust Funds will have been used up and the ongoing income to the program will be insufficient to meet all of the benefit obligations.

Key Dates for Social Security

2016 - First year expenditures exceed **tax** income; interest on Trust Funds will be needed to pay benefits

2025 - First year expenditures exceed **tax plus interest** income; Trust Fund assets will be needed to pay benefits

2038 - Year program Trust Fund assets are exhausted; Trust Fund income will be sufficient to pay 73% of benefits

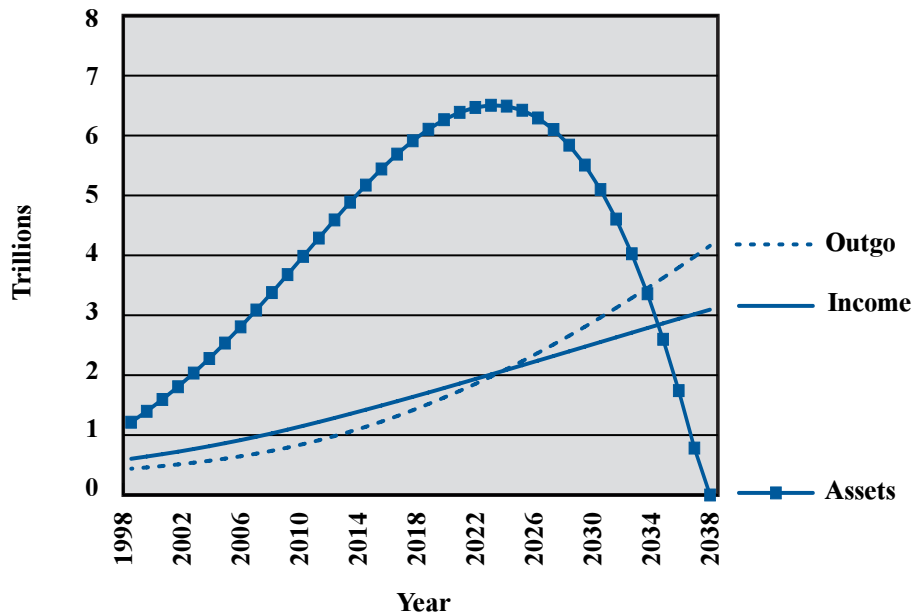
The Situation in 2038

By 2038, income to Social Security will be equal to about three-fourths (73 percent) of the promised benefits. However, the rate of growth in benefit obligations will increase faster than the rate of growth in tax income, so the percentage of the benefits that can be paid with current income will continue to decline, dropping to about two-thirds (67 percent) for the year 2075, and it is expected to continue to fall after that.

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Chart 8

**Social Security Income, Outgo, and Assets
(In current dollars)**



What Could Happen If No Action Is Taken Before 2038?

The Congress has never allowed the finances of the Social Security program to reach the point that benefits could not be paid, and it is not expected to do so in the future. In addressing the future solvency of the Social Security program, the Congress will have many different proposals to consider.

However, as a way of gauging the significance of the projected financing shortfall, it is useful to look at what could happen in the unlikely event that no action is taken to modify Social Security by 2038 when the Trust Funds are expected to fall to zero. At that point, there would be two basic alternatives — **large benefit cuts or large tax increases**.

A Hypothetical Illustration of the Impact of Cutting Benefits

As described above, the Social Security actuaries estimate that in 2038 current income to the system from taxes will be sufficient to pay about three-fourths of the Social Security

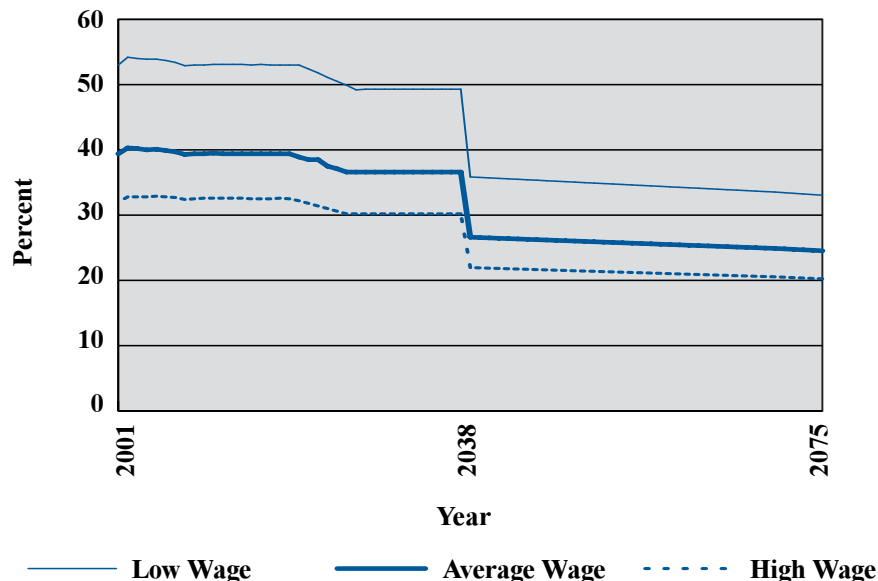
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benefits that beneficiaries are entitled to receive under current law. If this situation were met by cutting benefits across the board, there would have to be a 27 percent reduction in 2038 and even larger reductions in later years (ultimately reaching 33 percent in 2075). These reductions would affect both those becoming entitled to Social Security benefits in 2038 and later and those already receiving benefits at that time. To illustrate what it would mean if benefits were cut in this way:

- **The projected average monthly Social Security benefit in 2038 of about \$1,426 (in 2001 dollars) would fall to \$1,041, and would drop further in later years. Average benefits for low-wage earners would drop from \$864 to \$631.**
- **Initial Social Security benefits awarded to workers who retired in 2038 and after would replace significantly less of these workers’ pre-retirement wages compared to the benefits awarded to those who retired in prior years. As illustrated in the chart below, this “replacement rate” for workers who retire at age 65 would immediately fall**
 - from 49 percent to 36 percent for low earners;
 - from 37 percent to 27 percent for average earners; and
 - from 30 percent to 22 percent for high earners.
- Benefit cuts could mean that, in 2038 and later years, the percentage of aged people living in poverty would rise and there would be greater reliance on welfare programs, such as the Supplemental Security Income program. Lower benefits would also mean that the standard of living of retirees would fall quickly in 2038 and continue to fall over several decades.

Chart 9

Illustration of Decline in Replacement Rates for Workers Retiring at Age 65 if No Change is Made Until 2038



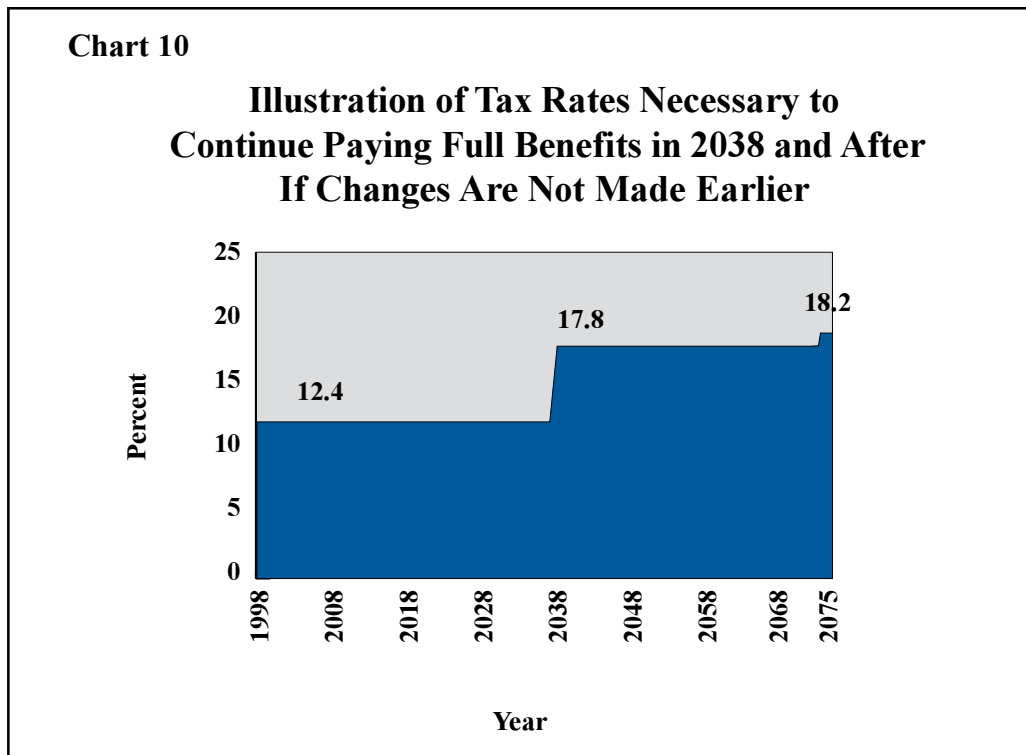
A Hypothetical Illustration of the Impact of Raising Taxes

In order to continue paying full benefits in 2038 and for another 37 years thereafter, the law would have to be changed to increase Social Security taxes by almost one-half, from the current 12.4 percent (6.2 percent each for employers and employees) to about 17.8 percent (8.9 percent each for employers and employees).

In 2038, for a worker earning the estimated average wage of \$48,786 (in 2001 dollars), this would mean an increase in Social Security taxes of \$1,317 a year (from \$3,025 to \$4,342), levied on both the worker and the worker's employer. For a worker earning the estimated maximum taxable amount of \$118,479 (in 2001 dollars), the increase would be \$3,199 a year (from \$7,346 to \$10,545).

Enacting this higher tax rate around 2038 would not be sufficient to assure that Social Security benefits could be paid for an indefinite period. By 2075, taxes would need to be raised again to keep the system in balance for future decades. However, the additional increase would be less than one percentage point (0.4 percent). (See Chart 10)

- A tax increase enacted close to the point of Trust Fund exhaustion would have little or no effect on people who have already retired. They would not be subject to the tax for the most part, and their benefits and replacement rates would remain at levels provided in present law.
- However, a tax increase would significantly affect people in the labor force (a group about twice as large as the retired population in 2038). And the younger the worker when the tax increase takes effect, the larger the impact, as the increased taxes accumulate over a working lifetime.



III. THE ADVANTAGES OF ACTING SOONER RATHER THAN LATER

The Reasons for Prompt Action

As time goes by, the size of the Social Security problem grows, and the choices available to fix it become more limited. Thus, there are important reasons for making changes earlier.

- **There are more choices available earlier.** For example, the sooner you change the way Social Security benefits are calculated or the age at which people can receive benefits, the more choices you have about how to make the changes.
- **Changes can be phased in more gradually.** By acting sooner, you can avoid making extreme changes at a future crisis point, and can instead reduce benefits or increase taxes in a more gradual way. Making gradual changes avoids creation of the large differences in benefit or tax levels between successive generations of retirees and workers that result when modifications are made precipitously.
- **The cost of repairing Social Security can be spread more evenly over more generations of workers and beneficiaries.** The cost of fixing Social Security will be the same whenever the changes are made, but the possibilities for distributing this cost across generations will diminish as time passes. The net effect of delaying action is to reduce or eliminate the burden of repairing Social Security on earlier generations and to place an even heavier burden on later generations.
- **The longer change is delayed, the heavier the impact will be on each individual who is affected.** Larger increases in tax rates or more severe cuts in benefits greatly increase the magnitude of the loss in well-being experienced by each individual. Conversely, making smaller changes in Social Security benefits or taxes soon, so that they could apply over several decades, would affect more people — but by less per person.
- **There will be more advance notice for those who will be affected, so they can plan for their retirement.** If, for example, there is to be a cut in benefits, workers need to know soon in order to be able to make career and investment choices that will make up for the loss of Social Security, and avoid the possibility that they could face a substantial reduction in benefits after they were at or near retirement and unable to make other arrangements.

As time goes by, the size of the Social Security problem grows, and the choices available to fix it become more limited.

- **Confidence in the ability of Social Security to continue to pay benefits to future generations of retirees will be strengthened.** According to a survey conducted earlier this year, only 34 percent of those polled were very or somewhat confident in the future financial viability of Social Security. There was a significant difference by age group. For respondents 55 and over the figure was 58 percent. However, for those 25-34 it was only 22 percent. Fixing the program quickly would eliminate the uncertainty that is currently eroding confidence in the program.
- **There will be less disruption in labor market participation.** Changes in either Social Security benefit levels or tax rates affect the work and retirement decisions of individuals and the hiring decisions of employers. Benefit cuts, for example, would likely induce some people to stay in the labor force longer, while on the other hand, payroll tax increases may in the short run cause employers to hire fewer workers and thus limit employment opportunities for older workers. The sooner that both employees and employers know about future changes in Social Security, the more time they have to alter their choices gradually and to avoid creating precipitous shifts in the availability of workers or jobs.
- **There will be less disruption in decisions about consumption and saving.** The Social Security system can affect household decisions about how much to consume and how much to save. Raising tax rates reduces the take-home pay of households and forces people to either consume less, save less, or work more. Reducing expected benefits during retirement years causes people to either save more during their working years or work more to make up for the loss, or to have a reduced standard of living in retirement. The sooner that households become aware of the changes so that they can plan ahead, the smaller would be the disruptions to consumption and saving.

Illustrating the Effects of Acting Sooner Rather Than Later

There are many ways to fix Social Security, and their impact depends on timing. The following illustrates how the effects on both individuals and generations would differ if certain basic changes were effective in **2002** or if they were delayed until **2020**.

Reduce the Social Security Cost-of-Living Adjustment (COLA)

Each year, Social Security benefits are raised to reflect increases in the Consumer Price Index (CPI). Many experts believe that the CPI currently overstates the rate of inflation and suggest changes that will make it more accurate.

***There are many ways to fix Social Security,
and their impact depends on timing.***

If the COLA were permanently reduced in 2002, Social Security benefits would be lower for everyone getting benefits at that time and for all future beneficiaries. Thus, the many beneficiaries born throughout the 20th century and now in their 60s, 70s, and beyond would share in bearing the cost of fixing Social Security.

If a COLA cut were put off until 2020, however, only people still alive in and after that year and receiving benefits would be affected. This means that most people born before about 1930 would not bear any cost of fixing Social Security and that people born in 1958 and later, who could retire beginning in 2020, would bear the heaviest costs throughout retirement.

In 2020, a COLA cut would have to be one-half again as large, about 1.5 percentage points, in order to solve the same proportion of Social Security's long-range (75-year) financing problem that a 1 percentage point cut would solve in 2002. A larger cut is needed in 2020 because it applies for fewer years. However, the total program costs over the 75-year period would be the same, no matter when a cut is made.

Because COLA cuts are compounded over time, they have a cumulative effect on benefit levels, which means that they have greater impact on those individuals who live longer and receive benefits over many years. Thus, a 1 percent 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.

Reduce the Benefit Formula

The formula used for calculating Social Security benefits in 2001 is 90 percent of the first \$561 of average monthly earnings, 32 percent of the amount above \$561 through \$3,381 of earnings, and 15 percent of additional covered earnings. The earnings amounts used in the formula are adjusted annually as average earnings in the U.S. economy increase. (The graduated structure of the formula results in more favorable treatment of workers with lower earnings because it replaces a greater percentage of pre-retirement earnings for them than it does for workers with higher earnings.)

One way to reduce program costs is to adjust the Social Security benefit formula for future beneficiaries by lowering the percentage of earnings that is replaced by benefits. A reduction in the current benefit formula beginning in 2002 would lower the percentage of earnings replaced by benefits for everyone eligible to get benefits in that year or later, that is, people born in 1940 and after. It would not affect people born earlier and already eligible for benefits.

In 2020, a COLA cut would have to be one-half again as large, about 1.5 percentage points, in order to solve the same proportion of Social Security's long-range (75-year) financing problem that a 1 percentage point cut would solve in 2002.

A reduction in replacement rates of about 5 percent beginning with individuals newly eligible in 2002 would solve 33 percent of the long-range financing problem. If a benefit formula change is delayed until 2020, the ultimate reduction in replacement rates would have to be larger, about 8 percent, to have the same impact on the long-range (75-year) actuarial deficit. By waiting until 2020, a larger reduction is needed because it applies for fewer years. However, in either case the total program costs would be the same for the 75-year period.

A cut for individuals newly eligible in 2020 would reduce retirement benefits for people born in 1958 and later, and would cause them to have substantially lower benefit levels than earlier generations. If the benefit formula is reduced uniformly across income levels by changing the benefit formula or by any other means, lower income beneficiaries would tend to be impacted more heavily because they have fewer alternative sources of retirement income to make up for the reduction in Social Security benefits.

Increase the Payroll Tax

Like benefit cuts, the size of the tax increases needed to fix the system would vary depending upon when they became effective. **An increase in 2002 of 1.9 percentage points in the current Social Security tax rate, from 12.4 to 14.3 percent (7.15 percent each for employees and employers), would resolve the Social Security funding shortfall until about 2075, when an additional tax rate increase would be needed. If the tax change is not put in place until 2020, the rate needed to resolve the financing problem until 2075 would be an increase of 3.0 percentage points, from 12.4 to 15.4 percent (7.7 percent each for employees and employers). By waiting until 2020, a larger increase is needed because it applies for fewer years. However, in either case, the total income to the system needed would be the same for the 75-year period.**

Social Security tax increases reduce take-home pay for everyone who is required to pay them at the time they become effective. However, because payroll taxes apply only to earnings below a certain annual limit (\$80,400 in 2001), tax increases have a relatively greater impact on those workers whose earnings are at or below this limit than on those with higher earnings or with income from sources other than earnings from work.

A reduction in replacement rates of about 5 percent beginning with individuals newly eligible in 2002 would solve 33 percent of the financing problem. If a benefit formula change is delayed until 2020, the ultimate reduction in replacement rates would have to be larger, about 8 percent, to have the same impact on the long-range (75-year) actuarial deficit.

Increasing Social Security tax rates in 2002 would allow the additional costs to be spread over many generations — in rough terms, people born as far back as the late 1930s would pay more. On the other hand, postponing a Social Security tax increase until 2020 would mean that most of the people born before 1958, who would be at or near retirement in that year, would avoid paying any of the additional taxes necessary to pay full benefits to them in retirement.

Establish Individual Investment Accounts

Establishing a system of individual investment accounts to replace part or all of the current Social Security system would involve a significant shift away from the current Social Security structure to a form of defined contribution system. Currently, Social Security is a defined benefit system under which individuals and their employers contribute a portion of earnings. Benefit levels are based on an individual's earnings using a formula that is specified in law. The various risks insured against are shared by all workers covered by the system. The system is, however, subject to changes in law to respond to changing circumstances, such as the demographic changes that will be occurring in the coming decades.

Defined contribution systems are essentially savings programs. Workers and their employers contribute to accounts for individual workers. Eventual returns under defined contribution systems are difficult to predict in advance because they depend upon the amounts invested, the length of time the funds are invested, the rate of return for individual investments over this period, and the disposition of the funds upon withdrawal. Workers may benefit from high returns on their investments, thereby enhancing their retirement income. In addition, proponents of individual accounts argue that because individual accounts would be pre-funded they could raise national saving, leading to higher national income in the future. However, under a defined contribution system, individuals also bear risks related to their personal circumstances, their personal choices on how their account is invested, and to more general economic conditions, which may or may not turn out favorably in their own particular case. The way accounts would be paid out to individuals upon retirement also matters — for example, whether they receive payments in a single lump sum or annuitized over their remaining lifetime after retirement.

In general, under a system of individual investment accounts, workers who have higher earnings and longer-term attachment to the workforce would fare better than workers who have lower earnings or whose working years are briefer. Establishing an individual account plan sooner rather than later would provide more of today's workers with a longer time period over which to build up their investments.

Increasing Social Security tax rates in 2002 would allow the additional costs to be spread over many generations — in rough terms, people born as far back as the late 1930s would pay more.

Various approaches to establishing individual investment accounts have been proposed. Some propose that the existing Social Security system be completely replaced by a system of mandatory individual investment accounts. Others propose a less comprehensive approach that would substitute individual accounts for some or all of the retirement portion of Social Security, but would retain other portions of the program, such as survivors and disability insurance. Still others propose that the current Social Security system be maintained essentially as it is, but that it be supplemented by a system of mandatory or voluntary individual investment accounts.

Any plan that establishes individual accounts and increases pre-funding would involve additional costs to workers during the decades when the plan was being phased in. These costs would be incurred because workers would have to pay for two retirement systems at the same time, both the system that is making payments to current beneficiaries, and the new individual account system that would pay for some or all of their own retirement. These transition costs would increase if the transition start date is delayed, particularly if it were to be delayed to the time when the baby boomers enter retirement.

The total contribution for workers during the transition will depend on when the new system starts. For example, if nothing is done until 2038 when the Trust Funds are exhausted, it would require a payroll tax of 17.8 percent (8.9 percent each for employees and employers) just to pay the following year's Social Security benefits, plus the additional amounts that would be needed to pay for the new system. If changes were made as early as 2002, a payroll tax of about 10.4 percent (5.2 percent each for employees and employers) would initially be sufficient to pay the next year's benefits, plus the additional amounts needed to pay for the new system.

The impact on individuals during the transition would also vary depending upon their age at the time the new system began. Under most methods of financing the transition, current workers, particularly those ages 25 to 55, would likely bear the highest transition costs until the new system was fully phased in. Younger workers would pay higher costs for some years, followed by lower costs after the new system was fully phased in.

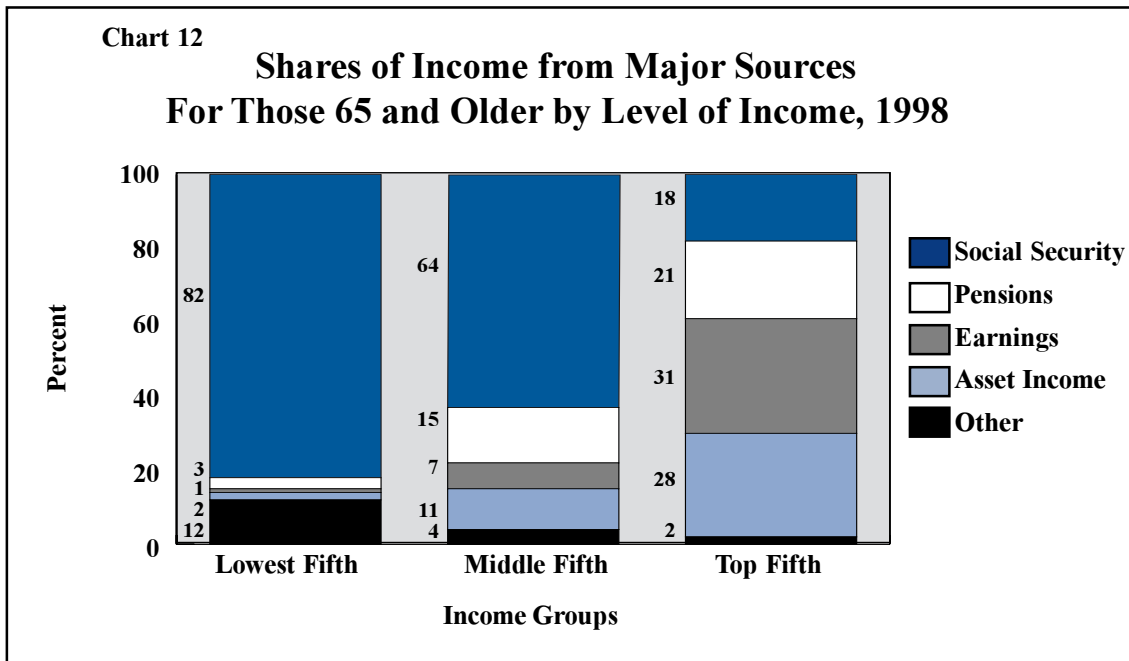
Adopting an individual account plan sooner rather than later would help in addressing transition costs because it could take advantage of the more than adequate financing that Social Security is expected to enjoy until 2016.

Establishing an individual account plan sooner rather than later would provide more of today's workers with a longer time period over which to build up their investments.

The Importance of Being Able to Plan for Retirement

Social Security is the major source of income for most of today's retirees, providing 40 percent of the total income of the aged and making up more than half of the income of about two-thirds of the aged. The importance of Social Security and other sources of income differs greatly across income groups. For example, Social Security provides over 82 percent of the total income of the low-income aged (those in the bottom fifth of the income distribution), with public assistance accounting for the next highest portion (10 percent). For 18 percent of beneficiaries, Social Security is their only income.

For the high-income aged (those in the top fifth), earnings are the most important source, amounting to almost one-third of total income. Social Security, pensions, and asset income each account for between 18 percent and 28 percent of income for the high-income aged.



For those still in the workforce who need to build reliable pension and investment strategies for retirement, knowing what they can expect from Social Security in future decades is a critical factor. Some changes in program benefits are already occurring. As discussed above, scheduled changes in the Social Security normal retirement age will result in a decline in Social Security replacement rates for all who retire in 2000 or later. And it is clear that other changes need to be made to remedy the funding problems created by the aging of the population. The effect of delaying change is to deprive workers unnecessarily of important information upon which they can reasonably base their lifetime plans for retirement security.

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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

Whatever changes are ultimately agreed upon, over the long term projected revenues will have to match projected spending if solvency is to be assured.

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.

Effect of Proposals to Address the Long-Range Solvency Problem

Options	Savings as % of Taxable Payroll	% of Social Security Deficit Resolved
Reduce the COLA by 0.5 percentage point below CPI, beginning in 2002.	0.75	40
Reduce the COLA by 1 percentage point below CPI, beginning in 2002.	1.44	77
Increase the number of years used to calculate benefits for retirees and survivors from 35 to 38 (phased in 2002-2006).	0.26	14
Increase the number of years used to calculate benefits for retirees and survivors from 35 to 40 (phased in 2002-2010).	0.42	22
Over a 31-year period, gradually reduce formula factors (i.e., 32%, 15%) in the benefit formula for middle and upper income workers, (ultimate reductions - 32% reduced to 21% and 15% reduced to 10%) for workers first eligible for benefits after 2031.	1.63	87
Reduce benefits across the board by 3% for those newly eligible for benefits, beginning in 2002.	0.37	20
Reduce benefits across the board by 5% for those newly eligible for benefits, beginning in 2002.	0.61	33
Phase in the currently scheduled increase in the normal retirement age to 67 by 2016 rather than 2027.	0.14	8
In addition to speeding up the increase to age 67, index the normal retirement age (by 1 month every 2 years) up to age 68.	0.43	23
In addition to speeding up the increase to age 67, index the normal retirement age (by 1 month every 2 years) up to age 70.	0.59	32
Reduce benefits by 10% beginning at family income of \$40,000 annually and an additional 10% for each additional \$10,000 (maximum reduction of 85%).	1.65	89
Raise payroll tax rates (for employees and employers combined) by 2.0 percentage points in 2002.	1.96	100
Raise payroll tax rates (for employees and employers combined) by 2.4 percentage points in 2020 and an additional 2.4 percentage points in 2050.	2.01	100

Effect of Proposals to Address the Long-Range Solvency Problem (Cont.)

Options	Savings as % of Taxable Payroll	% of Social Security Deficit Resolved
Tax Social Security benefits in a manner similar to private pension income. Phase out the lower income thresholds during 2002-2011.	0.44	24
Make all earnings subject to the payroll tax (but retain the cap for benefit calculations) beginning in 2002.	2.13	100
Make all earnings subject to the payroll tax and credit them for benefit purposes beginning in 2002.	1.63	88
Make 90% of earnings subject to the payroll tax and credit them for benefit purposes (phased in 2002-2011).	0.69	37
Cover newly hired State and local government employees beginning in 2002.	0.21	11
Invest 40% of the Trust Funds in stocks at 7% (or 6%) yield (phased in 2002-2016).	1.03 (or 0.78)	55 (or 42)
Transfer money from general revenues to offset the Trust Fund deficit.	Impact on Trust Fund deficit would depend on amount transferred.	
Use a portion of the payroll tax (e.g., 2 or 5 percent) to provide mandatory individual investment accounts.	Trust Fund deficit would be increased unless revenue loss is offset by benefit cuts.	
Allow or require workers to contribute to individual investment accounts funded by additional amounts withheld from wages.	No direct effect on the Trust Fund deficit. Benefits from these accounts would enhance retirement income.	
Use the budget surplus to establish individual investment accounts.	No direct effect on the Trust Fund deficit. Benefits from these accounts would enhance retirement income.	
Return to pay-as-you-go financing and allow workers to put money saved from temporary payroll tax reduction into individual investment accounts.	Trust Fund deficit would be eliminated by raising payroll taxes as needed to meet future benefit obligations.	

Issues Raised by Proposals to Address the Long-Range Solvency Problem

The many alternatives for changing Social Security will affect beneficiaries, workers and their families, and the economy in different ways, and individuals will have different views as to the relative importance of these effects. Below are some of the questions that are likely to be raised in the ongoing discussion around the future of Social Security.

Questions relating to such basic issues as the adequacy and fairness of benefits are subjective. How they are answered and how the answers are interpreted will vary, depending on individual points of view. In addition, there will be disagreement among experts on the answers to questions relating to such matters as how specific changes will affect the economy. However, the discussion that will take place in response to these questions will help to inform the decisions that policy makers and the public must make if the future solvency of Social Security is to be assured.

Will benefits be adequate?

- Do the benefits, combined with private savings and employer pensions, provide adequate retirement income protection for workers and their families?
- Is there adequate benefit protection for workers who become disabled?
- What benefits are provided for dependents and survivors when a worker retires, dies, or becomes disabled?
- Are beneficiaries adequately protected against inflation?
- Will there be more or fewer people living in poverty?

Will costs and benefits be fair?

- Are individuals in equal circumstances treated equally?
- Will workers get a fair return on their contributions?
- How will the burden of program changes be shared by current and future workers and beneficiaries?

The many alternatives for changing Social Security will affect beneficiaries, workers and their families, and the economy in different ways, and individuals will have different views as to the relative importance of these effects.

What are the risks?

- What are the economic and political risks for workers and beneficiaries? Who will bear them?

Are benefits progressive?

- Will lower wage workers receive proportionally higher benefits relative to their contributions than higher wage workers?

How will the economy be affected?

- What will happen to national savings? Will we save more or less than we do now?
- What will happen to economic growth? Will the economy grow faster or slower than it does now?

What will be the effect on the Federal budget?

- Does the proposal contribute to a budget surplus or a budget deficit? In the short term? In the long term?

What is the effect on the long-term obligations of the Federal government?

- What is the impact on total obligations?
- What is the impact on Medicare?
- Does the proposal contribute to the financial solvency and stability of Social Security for future generations?

What will be the effect on program efficiency and integrity?

- How will the proposal affect administrative efficiency?
- How will it affect the accuracy of benefit payments?

What will be the effect on public confidence and understanding?

- Will the proposal enhance or diminish public confidence in Social Security?
- How will the changes affect public understanding of the program?

GLOSSARY

Actuarial reduction. Downward adjustment of monthly benefit levels for early retirees so that total expected lifetime benefits paid to them over their longer periods of retirement will be roughly equal to what would have been paid to them had they waited until normal retirement age to receive benefits.

Disability. For Social Security purposes, the inability to engage in substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to last for a continuous period of not less than 12 months. Special rules apply for workers age 55 or older, or whose disability is based on blindness.

Earnings. Wages and salaries from employment and net earnings from self-employment.

- ◆ **Low**—Earnings that equal 45 percent of the average wage.
- ◆ **Average**—The average of all wages in the economy (\$30,470 in 1999).
- ◆ **High**—Earnings that equal 160 percent of the average wage.

Intermediate assumptions. The “best estimates” of the Trustees of the Social Security Trust Funds of likely future demographic and economic conditions.

Normal retirement age. The age at which a person can first become entitled to unreduced retirement benefits. For persons who reached age 62 before 2000, the normal retirement age is 65. It will 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 65 in 2003 (age 62 in 2000).

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 short-term economic fluctuations.

Payroll taxes. A tax levied on the gross covered wages of workers and on net earnings from self-employment.

Present value. The equivalent value, at the present time, of a future stream of payments (either income or expenditures). The present value of a future stream of payments may be thought of as the lump-sum amount that, if invested today, together with interest earnings would be just enough to meet each of the payments as they fell due. At the time of the last payment, the invested fund would be exactly zero.

Replacement rates. The portion of workers’ earnings replaced by Social Security benefits at retirement or disability.

Taxation of benefits. Amendments in 1983 required beneficiaries with income of more than \$25,000 if single, and \$32,000 if married, to include up to 50 percent of their benefits in their taxable income, beginning in 1984. Revenues from this provision are credited to the Social Security Trust Funds. Amendments in 1993 required beneficiaries with incomes of more than \$34,000 if single, and \$44,000 if married, to include up to 85 percent of their benefits in their taxable income, beginning in 1994. Revenues from this provision are credited to the Medicare Hospital Insurance Trust Fund.

Trust Funds. Separate accounts in the United States Treasury into which Social Security income from payroll taxes and other sources is deposited, and from which benefits and other expenses are paid. Funds not used for current expenses are invested in Government securities, as required by law, and the interest earned is also deposited in the Trust Funds.

THE SOCIAL SECURITY ADVISORY BOARD

Establishment of the Board

In 1994, when the Congress passed legislation establishing the Social Security Administration as an independent agency, it also created a 7-member bipartisan Advisory Board to advise the President, the Congress, and the Commissioner of Social Security on matters relating to the Social Security and Supplemental Security Income (SSI) programs. The conference report on this legislation passed both Houses of Congress without opposition. President Clinton signed the Social Security Independence and Program Improvements Act of 1994 into law on August 15, 1994 (P.L. 103-296).

Advisory Board members are appointed to 6-year terms, made up as follows: 3 appointed by the President (no more than 2 from the same political party); and 2 each (no more than one from the same political party) by the Speaker of the House (in consultation with the Chairman and Ranking Minority Member of the Committee on Ways and Means) and by the President pro tempore of the Senate (in consultation with the Chairman and Ranking Minority Member of the Committee on Finance). Presidential appointees are subject to Senate confirmation. Board members serve staggered terms. There is currently one vacancy on the Board.

The Chairman of the Board is appointed by the President for a 4-year term, coincident with the term of the President, or until the designation of a successor.

Members of the Board

Stanford G. Ross, Chairman

Stanford Ross is a partner in the law firm of Arnold & Porter, Washington, D.C. He has dealt extensively with public policy issues while serving in the Treasury Department, on the White House domestic policy staff, as Commissioner of Social Security, and as Public Trustee of the Social Security and Medicare Trust Funds. He is a Founding Member and a former Director and President of the National Academy of Social Insurance. He has provided technical assistance on Social Security and tax issues under the auspices of the International Monetary Fund, World Bank, and U.S. Treasury Department to various foreign countries. He has taught at the law schools of Georgetown University, Harvard University, New York University, and the University of Virginia, and has been a Visiting Fellow at the Hoover Institution, Stanford University. He is the author of many papers on Social Security and Federal taxation subjects. Term of office: October 1997 to September 2002.

Jo Anne Barnhart

Jo Anne Barnhart is a political consultant and public policy consultant to State and local governments on welfare and social services program design, policy, implementation, evaluation, and legislation. From 1990 to 1993 she served as Assistant Secretary for Children and Families, Department of Health and Human Services, overseeing more than 65 programs, including Aid to Families with Dependent Children, the Job Opportunities and Basic Skills Training program,

Child Support Enforcement, and various child care programs. Previously, she was Minority Staff Director for the U.S. Senate Committee on Governmental Affairs, and legislative assistant for domestic policy issues for Senator William V. Roth. Ms. Barnhart served as Political Director for the National Republican Senatorial Committee. First term of office: March 1997 to September 1998; current term of office: October 1998 to September 2004.

Martha Keys

Martha Keys served as a U.S. Representative in the 94th and 95th Congresses. She was a member of the House Ways and Means Committee and its Subcommittees on Health and Public Assistance and Unemployment Compensation. Ms. Keys also served on the Select Committee on Welfare Reform. She served in the executive branch as Special Advisor to the Secretary of Health, Education, and Welfare and as Assistant Secretary of Education. She was a member of the 1983 National Commission (Greenspan) on Social Security Reform. Martha Keys is currently consulting on public policy issues. She has held executive positions in the non-profit sector, lectured widely on public policy in universities, and served on the National Council on Aging and other Boards. Ms. Keys is the author of *Planning for Retirement: Everywoman's Legal Guide*. First term of office: November 1994 to September 1999; current term of office: October 1999 to September 2005.

David Podoff

David Podoff is visiting Associate Professor at the Department of Economics and Finance at the Baruch College of the City University of New York. Recently, he was Minority Staff Director and Chief Economist for the Senate Committee on Finance. Previously, he also served as the Committee's Minority Chief Health and Social Security Counselor and Chief Economist. In these positions on the Committee he was involved in major legislative debates with respect to the long-term solvency of Social Security, health care reform, the constitutional amendment to balance the budget, the debt ceiling, plans to balance the budget, and the accuracy of inflation measures and other government statistics. Prior to serving with the Finance Committee he was a Senior Economist with the Joint Economic Committee and directed various research units in the Social Security Administration's Office of Research and Statistics. He has taught economics at the University of Massachusetts and the University of California at Santa Barbara. He received his Ph.D. in economics from the Massachusetts Institute of Technology and a B.B.A. from the City University of New York. Term of office: October 2000 to September 2006.

Sylvester J. Schieber

Sylvester Schieber is Director of the Research and Information Center at Watson Wyatt Worldwide, where he specializes in analysis of public and private retirement policy issues and the development of special surveys and data files. From 1981 to 1983, Mr. Schieber was the Director of Research at the Employee Benefit Research Institute. Earlier, he worked for the Social Security Administration as an economic analyst and as Deputy Director at the Office of Policy Analysis. Mr. Schieber is the author of numerous journal articles, policy analysis papers, and several books including: *Retirement Income Opportunities in An Aging America: Coverage and Benefit Entitlement*; *Social Security: Perspectives on Preserving the System*; and *The Real Deal: The History and Future of Social Security*. He served on the 1994-1996 Advisory Council on Social Security. He received his Ph.D. from the University of Notre Dame. Term of office: January 1998 to September 2003.

Gerald M. Shea

Gerald M. Shea is currently assistant to the president for Government Affairs at the AFL-CIO. He previously held several positions within the AFL-CIO, serving as the director of the policy office with responsibility for health care and pensions, and also in various executive staff positions. Before joining the AFL-CIO, Mr. Shea spent 21 years with the Service Employees International Union as an organizer and local union official in Massachusetts and later on the national union's staff. He was a member of the 1994-1996 Advisory Council on Social Security. Mr. Shea serves as a public representative on the Joint Commission on the Accreditation of Health Care Organizations, is a founding Board member of the Foundation for Accountability, Chair of the RxHealth Value Project, and is on the Board of the Forum for Health Care Quality and Measurement. He is a graduate of Boston College. First term of office: January 1996 to September 1997; current term of office: October 2000 to September 2004.

Members of the Staff

Margaret S. Malone, Staff Director

Michael Brennan

Beverly Rollins

George Schuette

Wayne Sulfridge

Jean Von Ancken

David Warner

MAKING ASSUMPTIONS ABOUT THE FUTURE

Projections about the financial status of the Social Security program are based in part on things already known and in part on things about which assumptions have to be made regarding what will happen in the future.

With respect to demographic factors, all of those who will be retiring and most of those who will be in the workforce over the next few decades have already been born, so the sizes of the working and retired populations over that period are fairly well known. But there are some uncertainties concerning the population; for example, the rate at which life expectancy will increase and the number of immigrants who will join the workforce.

Economic factors are also critical in making projections about the future of Social Security, and they are far less certain than the key demographic factors. Perhaps most important is how fast wages will rise relative to increases in prices; that is, the increase in “real wages.” If real wage increases (wage increases relative to price increases) are greater than currently anticipated, then the Social Security program will be in a position to meet more of its future benefit obligations. But if they are not as high as now projected, Social Security’s ability to pay benefits will be reduced.

Unemployment and labor force assumptions are also important. If more people are working in the future than are now expected (including possibly a greater portion of the elderly), there will be more workers paying taxes to support beneficiaries, and the financing picture will be improved. However, if there are fewer workers the financing picture will be worse than expected.

Actuaries in the Social Security Administration analyze these and other data in order to project the future of the Social Security program. Their projections help the Congress, the President, and the public evaluate the financial condition of the program and the impact of any changes.

The numbers used in this document are derived primarily from information provided by the Office of the Chief Actuary of the Social Security Administration and reflect the intermediate assumptions of the 2001 Report of the Trustees of the Old-Age, Survivors, and Disability Insurance Trust Funds. Information on income of the aged comes from SSA’s Office of Research, Evaluation, and Statistics, and data on foreign populations is based on projections by the U.S. Census Bureau. Information on the budget comes from the fiscal year 2002 President’s Budget and supporting materials.

Social Security Advisory Board
400 Virginia Avenue, SW
Suite 625
Washington, D.C. 20024
Tel: (202) 475-7700
Fax: (202) 475-7715
www.ssab.gov