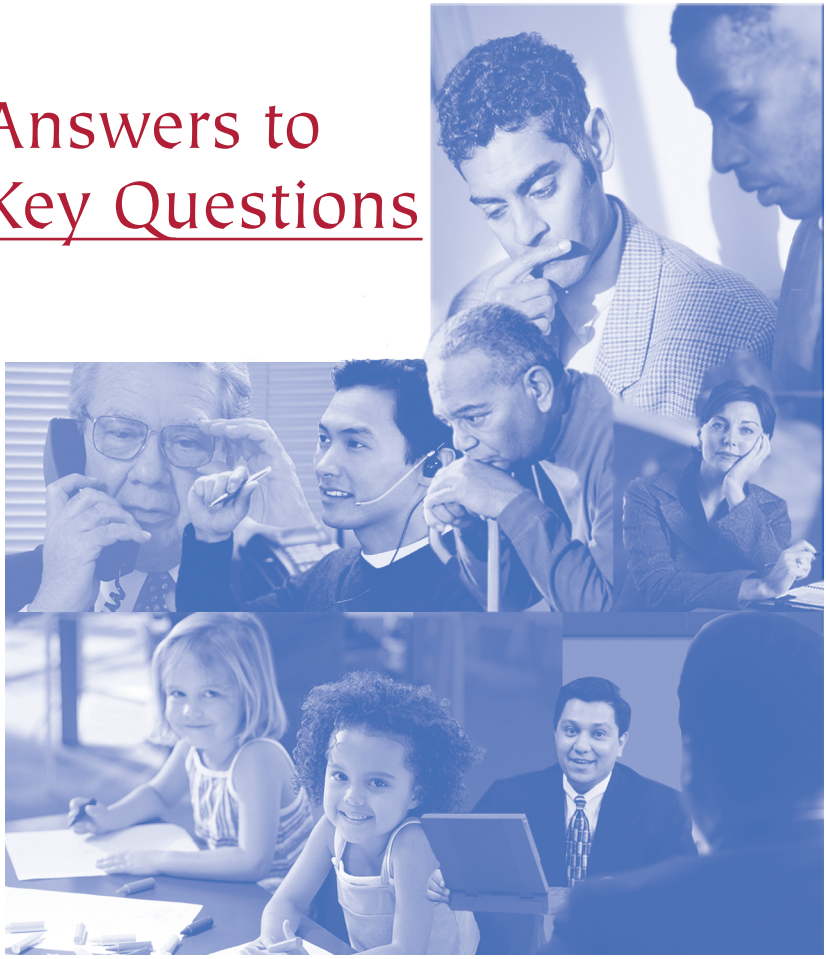
UNITED STATES
GOVERNMENT ACCOUNTABILITY OFFICE

Social Security REFORM

Answers to Key Questions



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ERRATA

On May 18, 2005, this document was revised as follows: text was revised on pages 7, 21, and 42; numerical changes were made in table 2 on page 16; and revisions were made to figure 1 on page 4, figure 4 on page 9, figure 5 on page 17, and figure 11 on page 28. In addition, revisions were made to figure 12 on page 29 and figure 13 on page 30 to correct color-related problems that occurred only in the printed version.

PREFACE

The sooner our nation acts to address Social Security's long-term financial challenges, the easier it will be to successfully meet them. Once explained, the choices we face are not difficult to understand, but they are difficult to make. They affect both how much Americans pay for Social Security and how much they receive from the program. They require changes that not only will affect us but have implications for future generations. They also are difficult because they involve deeply felt values, such as community, individualism, fairness, and human dignity. This guide tries to boil down the complexities of Social Security and the implications of reform to the basic choices we face as a nation.

Social Security eventually provides benefits to tens of millions of Americans: workers and the families of workers who become disabled or die, as well as to those who retire. Those benefits are designed to replace some of the earnings that such workers lose, but not all of them. Social Security was never intended to guarantee an adequate income. Also, they are available only to workers, and their families, who have contributed to the system.

People are living longer than ever before, and they are expected to live even longer in the future. If workers keep retiring at the same age as they do now, they will collect retirement benefits for more years than past workers did. If the level of those benefits relative to wages stays the same, then lifetime benefits would cost more simply because those lifetimes are longer. So this longer life expectancy presents workers with a basic choice: How much of their earnings should they spend during their peak employment years, and how much should they save for retirement? Yet, workers also have other options. They can choose to work longer and have more total earnings to spread over their lifetimes; they can also choose to invest their savings in ways that earn higher returns, but to do so they have to take more risk.

With or without Social Security, workers face these basic choices as they plan for longer lives. The choices we collectively face for Social Security

are very similar for the very same reasons. And with Social Security, the choices will affect not only the program and its beneficiaries but also the federal budget and the national economy.

This guide provides answers to questions about the most basic aspects of Social Security and reform issues in a concise and easy-to-understand format. We provide straightforward answers to how Social Security works, why it needs reform, what the basic options are, and how to assess their implications. For readers interested in a deeper and more detailed discussion, we include a bibliography of related GAO products. A glossary defining key terms is included at the back of this document.

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I. Basically, how does Social Security work now?

Social Security's Goals

1. How did Social Security get started?

When Social Security was enacted, in 1935, the nation was in the midst of the Great Depression. About half of the elderly (people age 65 and over) depended on others for their livelihood, and roughly one-sixth received public charity. Many had lost their savings. Social Security was created to help ensure that the future elderly would have adequate retirement incomes and would not have to depend on welfare. It would provide benefits that workers had earned because of their own contributions and those of their employers. In 1939, coverage was extended to dependents and survivors. The Disability Insurance (DI) program was added in 1956. Officially, Social Security is now called the Old-Age, Survivors, and Disability Insurance (OASDI) program.

2. What are Social Security's goals?

Helping ensure adequate retirement income is a fundamental goal of Social Security.[1] While Social Security was never intended to guarantee an adequate income by itself, it provides an income base upon which to build. At the same time, Social Security is intended to reduce dependency on welfare, so the system is funded by workers' contributions that establish their eligibility to receive benefits. Both contributions and benefits are based on earnings. Accordingly, another goal of the program is to ensure that benefits bear some relationship to contributions. This goal is known as individual equity.[2] The Social Security program, in effect, balances the goal of income adequacy and individual equity. The benefit formula seeks to ensure adequacy by providing somewhat higher benefits, relative to wages, for lower-income workers than higher-income workers. At the same time, the formula also promotes some degree of individual equity by ensuring that benefits are somewhat higher for workers with higher lifetime earnings.

3. How well has Social Security worked?

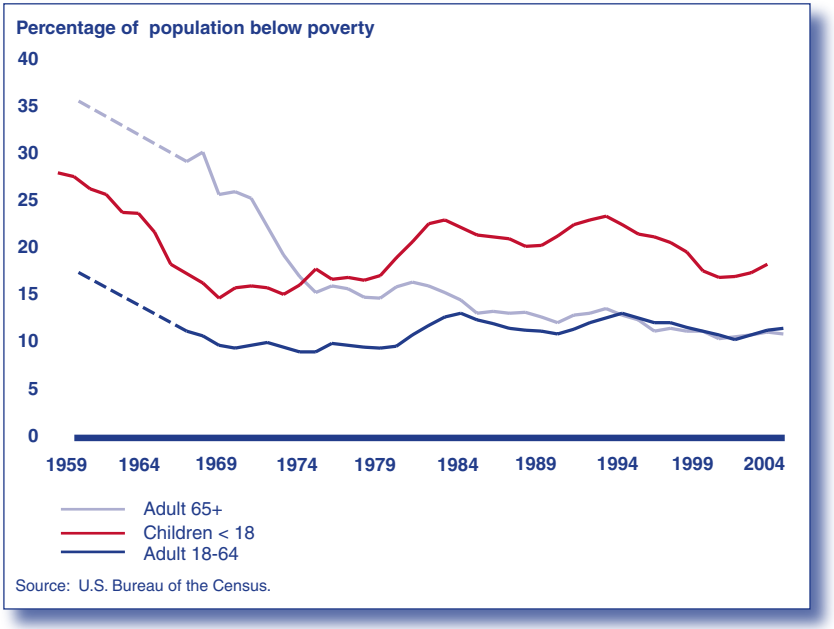
In 2004, Social Security paid almost $493 billion in benefits to more

[1] *GAO, Social Security: Program's Role in Helping Ensure Income Adequacy,* GAO-02-62 (Washington, D.C.: Nov. 30, 2001).

[2] *GAO, Social Security: Issues in Comparing Rates of Return With Market Investments*, GAO/HEHS-99-110 (Washington, D.C.: Aug. 5, 1999).

than 47 million people. This currently represents 22 percent of the federal budget and 4.3 percent of our nation's gross domestic product (GDP).[3] Social Security has contributed to reducing poverty among the elderly. (See fig. 1.) Since 1959, poverty rates for the elderly have dropped by more than two-thirds, from 35 percent to about 10 percent in 2003. While poverty rates for the elderly in 1959 were higher than for children or for working-age adults (aged 18 to 64), in 2003 they were lower than for either group. Factors other than Social Security, for example, employer-provided pensions have also contributed to lower poverty for the elderly. Still, for about half of today's elderly, their incomes net of Social Security benefits are below the poverty threshold, the level of income needed to maintain a minimal standard of living. Nearly two-thirds of the elderly get at least half of their income from Social Security. One in five elderly Americans has no income other than Social Security.

Figure 1: Poverty Rates for Elderly Have Declined Faster than for Other Groups



Note: Data for years indicated by dashed lines were not available but are available for 1959.

Moreover, poverty is higher for some subgroups of the elderly than for the elderly as a whole. Women, members of minorities, and persons aged 75 and older are much more likely to be poor than other elderly persons. For example, compared with 10 percent for all elderly persons (aged 65 and older) in 2003, poverty rates were 21 percent for all elderly women living alone, roughly 22 percent for elderly blacks and Hispanics, and about 32 percent for black women 75 and older. Unmarried women make up more than 70 percent of poor elderly households, although they account for only 45 percent of all elderly households.

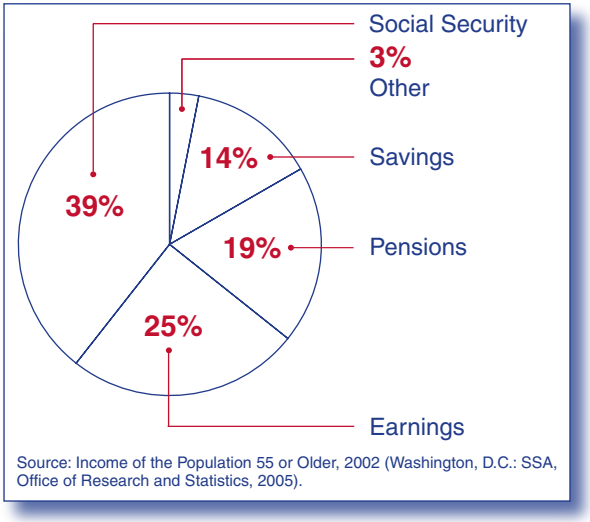
At about 19 percent, poverty rates in 2000 were much higher for disabled workers age 16-64 than for the elderly (13.2 percent). Like the rates for the elderly, poverty rates for disabled workers are higher for women, minorities, unmarried persons, and those living alone. Social Security provides an important source of income for the disabled. In 1999, disabled workers made up 11 percent of all OASDI beneficiaries. As with the elderly, Social Security is a major component (38 percent) of family income for disabled worker families. Also, 48 percent of disabled worker families get half of their income or more from Social Security, as of 1999, while 6 percent have no other income.

4. What are the sources of income for the elderly?

The four major sources of income for the elderly are Social Security, employer pensions, income from saved assets, and earnings. While Social Security provides income to 90 percent of elderly households, it provides just 39 percent of their total retirement income. (See figs. 2 and 3.) Pensions, savings, and earnings provide income to considerably fewer households but together provide 58 percent of elderly households' total income. They largely determine which households have the highest retirement incomes. Less than 3 percent comes from other sources, and less than 1 percent comes from public assistance. Medical benefits, including Medicare and Medicaid, also help relieve a major cost burden on the elderly, especially as health care costs grow much faster than inflation.

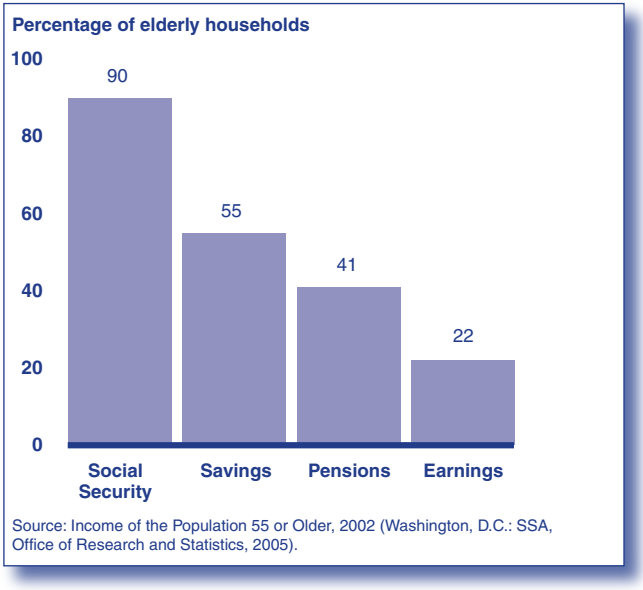
[3]GDP is the value of all goods and services produced within the United States in a given year and is conceptually equivalent to incomes earned in production.

Figure 2: Elderly Households' Sources of Income, 2002



Source: Income of the Population 55 or Older, 2002 (Washington, D.C.: SSA, Office of Research and Statistics, 2005).

Figure 3: Percentage of Elderly Households Receiving Each Type of Income, 2002



Source: Income of the Population 55 or Older, 2002 (Washington, D.C.: SSA, Office of Research and Statistics, 2005).

5. Who gets benefits?

Social Security benefits are paid to workers who meet requirements for the time they have worked in "covered employment," that is, jobs through which they have paid Social Security taxes. Social Security covers about 96 percent of all U.S. workers; the vast majority of the rest are state, local, and federal government employees.[4] Typically, workers must contribute for a total of 40 quarters (or ten years in total) to qualify, though the requirements are different if they become disabled or die. Workers and their dependents generally become eligible to collect benefits when the workers reach age 62, become disabled, or die.

Benefits are paid to family members of workers under certain circumstances. Spouses and divorced spouses of eligible workers may also be eligible at age 62 but can be eligible at younger ages if they are disabled, widowed, or caring for eligible children. An eligible worker's children under 18 are also eligible, and adult children are eligible if they became disabled before age 22. Dependent parents and grandchildren of eligible workers are also eligible for survivors benefits under certain circumstances.

Some workers qualify for Social Security benefits from both their own work and their spouses'. Such workers are called dually entitled spouses. Such workers do not receive both the benefits earned as a worker and the full spousal benefit; rather the worker receives the higher amount of the two.

6. What benefits does Social Security offer?

Social Security benefits are designed to partially replace earnings that workers lose when they retire, become disabled, or die. As a result, the first step of the benefit formula calculates a worker's average, indexed monthly earnings (AIME), which is based on the highest 35 years' earnings on which they paid Social Security taxes. The formula adjusts these lifetime earnings, or indexes them to changes in average wages, to account for the fact that

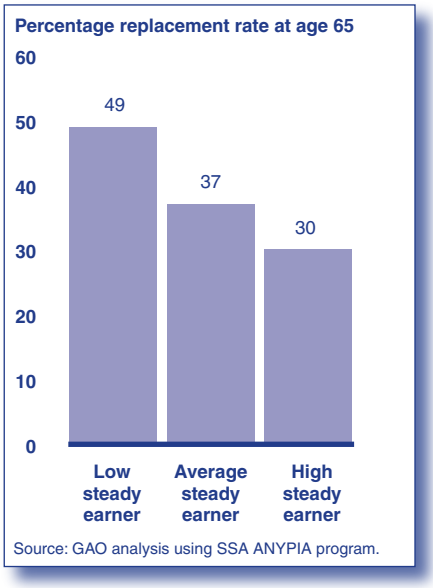
[4]About one-fourth of public employees do not pay Social Security taxes on the earnings from their government jobs. Historically, Social Security did not require coverage of government employees because there was concern over the question of the federal government's right to impose a tax on state governments and some had their own retirement systems. In 1983, Congress extended mandatory coverage to newly hired federal workers and to all members of Congress, regardless of when they entered Congress. See GAO, *Social Security: Issues Relating to Noncoverage of Public Employees,* GAO-03-710T (Washington, D.C.: May 1, 2003).

earnings across all workers grow over time.

Then, the benefit formula replaces a percentage of those pre-retirement earnings, replacing a larger share of earnings for lower earners than for higher earners. For example, retired workers receive benefits that equal about 50 percent of pre-retirement earnings for a worker with relatively lower earnings (45 percent of the average wage) but only about 30 percent of earnings for one with relatively higher earnings (160 percent of the average wage). To help ensure that beneficiaries have adequate incomes, Social Security's benefit formula is designed to be progressive, that is, to provide disproportionately larger benefits, as a percentage of earnings, to lower earners than to higher earners.[5]

[5]GAO, *Social Security: Distribution of Benefits and Taxes Relative to Earnings Level,* GAO-04-747 (Washington, D.C.: June 15, 2004).

Figure 4: Benefit Formula Provides Higher Replacement Rates for Lower Earners



Note: Replacement rates are the annual retired worker benefits at age 65 for workers born in 1985 divided by the earnings in the previous year. For such workers, the full retirement age will be 67. Steady earners have earnings equal to a constant percentage of Social Security's Average Wage Index in every year of their careers. Those percentages are 45, 100, and 160, respectively, for low, average, and high earners. Benefits for disabled workers use the same formula, but since workers become disabled at different ages, it is more difficult to calculate a consistent replacement rate. See GAO, Social Security: Distribution of Benefits and Taxes Relative to Earnings Level, GAO-04-747 (Washington, D.C.: June 15, 2004) for more on replacement rates.

Finally, the benefit formula makes other adjustments to reflect various other provisions, such as those relating to early or delayed retirement, type of beneficiary, and maximum family benefit amounts. In addition, once payments have begun, Social Security benefits are adjusted annually to reflect inflation.

7. When can people get benefits?

For retired workers and their dependents, Social Security pays full benefits at the full retirement age, also known as the normal retirement age (NRA), which historically has been age 65. However, under current law, the full retirement age is gradually increasing, beginning with retirees born in 1938, and will reach 67 for those born in 1960 or later. (See table 1.) People may choose to retire at age 62 and receive reduced benefits.[6] The reduction

for early retirement takes account of the longer period of time over which benefits will be paid.

Table 1: Full Retirement Age is Increasing

Year of Birth	Full Retirement Age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Source: SSA.

For disabled workers and their dependents, Social Security pays benefits for workers who are unable to work in any job and whose disabilities are expected to last for at least 1 year or to result in death. Social Security does not pay benefits for short-term or partial disability. Also, benefits do not begin until a worker has been disabled for 5 full consecutive months.

For survivors of deceased workers, Social Security pays benefits upon the death of the worker for those who satisfy the relevant age requirements. For example, a widow can start receiving benefits as early as age 60 or, if she is disabled, age 50.

8. How much interest do workers' contributions earn?

Workers do not earn interest on their Social Security contributions as they would on a savings account. Their contributions are not deposited in interest-bearing accounts for individual workers. Rather, their contributions

[6]Social Security also pays reduced benefits as early as age 62 for spouses, and widow(er)s.

are credited to the Social Security trust funds, which are primarily used to pay current benefits. Any contributions not used for current benefits are invested in interest-bearing federal government securities that are not readily marketable but backed by the full faith and credit of the U.S. government. The benefit payments paid to any given individual are derived from a formula that does not use interest rates or the amount of contributions but rather uses the individual's average indexed lifetime earnings as a basis for determining benefits.

In technical terms, Social Security provides a defined-benefit pension, not a defined-contribution pension. A defined-benefit pension generally provides a periodic benefit based on a specific formula generally linked to each worker's earnings and years of employment. In contrast, a defined-contribution pension resembles an individual savings or investment account; retirement income from this type of pension depends on the total amount of contributions to the account and any investment earnings. As an example, 401(k) accounts are a type of defined-contribution pension.

The benefits workers receive under Social Security do, however, reflect a rate of return that they implicitly receive on their contributions.[7] This implicit rate equals the interest rate that workers would hypothetically have to earn on their contributions to pay exactly for all the benefits they and their families will receive over the course of their lives. This implicit rate of return provides one measure of individual equity, that is, the relationship between contributions and benefits. It is important to recognize that this implicit rate of return individuals receive on their contributions is not the same as the interest that the Social Security trust funds earn on their assets. Implicit rates of return for individuals depend on the relationship between lifetime benefits and contributions, while the interest earned by the trust funds reflects the prevailing rates of interest in the market.

Implicit rates of return that individual workers receive on their Social Security contributions vary significantly across a number of dimensions. The variations mostly reflect several types of income transfers that the program is designed to provide as part of its social insurance function. Implicit returns vary by birth year, reflecting the program's income transfers to the first generations of retirees from subsequent generations.[8] For example,

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[7]GAO, *Social Security: Issues in Comparing Rates of Return With Market Investments,* GAO/HEHS-99-110 (Washington, D.C.: Aug. 5, 1999).

the inflation-adjusted (or "real") implicit rate of return averaged more than 25 percent annually for the earliest retirees covered by Social Security. For the baby boomers (those people born between 1946 and 1964), the real implicit rate of return is projected to be around 2 percent, according to a Social Security Administration (SSA) study.[9] Implicit returns that workers receive also vary on average by their earnings level, by the number of their dependents and survivors, by their life expectancies, and whether they become disabled. These characteristics vary by race and gender and therefore the associated implicit rates of return do also.

9. What is social insurance?

Under a social insurance program, society as a whole insures its members against various risks they all face, and members pay for that insurance through contributions to the system. Social Security is a social insurance program through which the government assumes some of the responsibility for a variety of risks that workers face regarding their retirement income security. Such risks include individually based risks, such as how long they will be able to work, how long they will live, whether they will be survived by a spouse or other dependents, how much they will earn and save over their lifetimes, and how much they will earn on retirement savings. Workers also face some collective risks, such as the performance of the economy and the extent of inflation. Different types of retirement income embody different ways of assigning responsibility for these risks. For example, employers sponsoring defined benefit pension plans bear the risk of investing a plan's assets and ensuring that contributions are adequate to fund promised benefits. In contrast, individuals saving for retirement bear that investment risk.

Social Security's Revenues

10. Where do Social Security's revenues come from?

Social Security's revenues generally come from three sources: contributions in the form of payroll taxes, interest on the trust funds, and

[8]While these early beneficiaries may have received a substantial income transfer within the Social Security system, as a group they contributed substantial amounts outside the system to the retirement incomes of their parents' generation, which did not qualify for Social Security benefits. Such contributions included not only income support that some provided to their own parents but also taxes and charitable contributions that paid for other forms of support.

[9]Dean R. Leimer, Cohort-Specific Measures of Lifetime Net Social Security Transfers, working paper 59 (Washington, D.C.: SSA, Office of Research and Statistics, Feb. 1994)

income taxes attributable to Social Security benefits. In 2004, the shares of total revenue were

- 84.1 percent from payroll taxes,
- 13.5 percent from interest on the trust funds, and
- 2.4 percent from income taxes on Social Security benefits.

11. How much is the Social Security payroll tax?

In 2005, workers pay a payroll tax of 6.2 percent of their covered wage earnings up to $90,000 into Social Security, that is, into the OASDI trust funds. Their employers pay an equal amount for a combined total tax rate of 12.4 percent. Most analysts agree that employees ultimately pay the employers' share because employers pay lower wages than they would if the employers' contribution did not exist. Self-employed workers pay 12.4 percent, but they are allowed an income tax deduction for half of the payroll tax. This deduction parallels the favorable tax treatment that employers receive on their share of the payroll tax. Of the 12.4 percent tax, 1.8 percent is allocated specifically to Disability Insurance. The other 10.6 percent is allocated to Old-Age and Survivors Insurance. In addition, workers and their employers each pay a payroll tax of 1.45 percent of all wage earnings (without any cap) into Medicare.

When Social Security started collecting payroll taxes in 1937, the total payroll tax rate was 2 percent. Higher rates were not necessary because only a small share of the elderly had contributed enough to the program to qualify for benefits. As the system matured—that is, as each year passed and another group of people reaching retirement age qualified for benefits—benefit costs increased and tax rates eventually were increased accordingly. When the program began, payroll taxes were anticipated to increase over time with the growth in benefit payments as the system matured and more retirees received benefits.

12. Why is there a cap on taxable earnings?

The cap on taxable earnings in 2005 is $90,000. This cap is technically known as the contribution and benefit base because the same cap also effectively limits the earnings that can be used in the benefit formula. This in turn limits the size of benefits, reflecting the program's role of only providing for a floor of protection. Limiting the size of benefits also limits the program's costs and the payroll taxes needed to pay for them.

The cap on taxable earnings has also changed over time. The maximum annual earnings subject to the payroll tax were only $3,000 in 1937. However, in 1937, 97 percent of all covered workers had total earnings below $3,000. In recent years, about 94 percent have had total earnings below the taxable maximum.

13. What interest rate do the Social Security trust funds earn?

In 2004, the Social Security trust funds earned interest at an effective nominal annual rate of 5.7 percent (or 3.1 percent after inflation). By law, the Social Security trust fund invests in securities backed by the federal government and receives a relatively low return that reflects the low level of relative risk. The interest rate on special Treasury securities is equal, at the time of issue, to the average market yield on outstanding marketable government securities not due or redeemable for at least 4 years. This statutory rate was intended to confer neither an advantage nor a disadvantage on the trust fund but was intended to approximate how much it would cost the government to borrow from the public for the long term.

14. Why are Social Security benefits taxed?

Since 1984, some Social Security beneficiaries have had to pay federal income tax on up to one-half of their Social Security benefits.[10] These income tax revenues are returned to the Social Security trust funds. In 2004, they provided 2 percent of the trust funds' total income.[11] Currently, about two-thirds of Social Security beneficiaries are not affected by the taxation of benefits. This tax treatment of Social Security benefits roughly parallels the tax treatment of similar defined-benefit pension benefits.[12]

In addition, because of changes in 1993, some of these beneficiaries also have to pay federal income taxes on an additional 35 percent of their benefits. However, the additional revenues collected from this source are

[10]Individual income tax filers pay this tax if their adjusted gross income plus tax-exempt interest income plus one-half their Social Security benefits exceeds $25,000. A married couple filing jointly will pay the tax if this income exceeds $32,000. These levels are not adjusted for inflation, so the percentage of beneficiaries paying tax on Social security benefits is expected to rise in the future.

[11]The Social Security trust funds also receive interest income that is not subject to tax. In 2004, 14 percent of the trust funds' income came from interest on the Social Security trust funds.

[12]In most defined-contribution pensions, such as 401(k) plans, contributions are made from tax-deferred income and participants are subject to income taxation on all benefits they receive.

dedicated to the Hospital Insurance (HI, or Medicare Part A) trust fund and do not increase OASDI revenues.

15. What does "pay-as-you-go financing" mean?

Social Security is financed largely on a pay-as-you-go basis. In a pay-as-you-go system, contributions that workers make in a given year are used primarily to pay beneficiaries in that same year. Social Security is now temporarily deviating from pure pay-as-you-go financing by building up reserves that are by law invested in Treasury bonds. This situation has arisen partly because the baby boom generation makes the size of the workforce larger relative to the beneficiary population. In contrast, in a fully funded, or advance funded, system, contributions for a given year are put aside to pay for future benefits. The investment earnings on these funds contribute considerable revenues and reduce the size of contributions that would otherwise be required to pay for the benefits. Defined-contribution pensions and individual retirement accounts (IRAs) are fully funded by definition, as the benefits received equal the funds accumulated in the account. Also, defined-benefit employer pensions are designed with the goal of being advance funded: however, at any given point in time total assets may be more or less than accrued liabilities and obligations. The pension funds accumulate substantial assets that constitute a large share of national saving.

Virtually from the beginning, Social Security was financed on a pay-as-you-go basis. Congress had rejected the idea of advance funding for the program. Many expressed concern that if the federal government amassed huge reserve funds, it would find a way to spend them. Social Security has run a surplus (e.g. $151 billion in fiscal 2004). Also, if the trust funds were invested in private securities, some people would be concerned about the influence that government could have on the private sector (e.g. social investing).

Social Security and the Federal Budget

16. How do the Social Security trust funds relate to the federal budget?

The Social Security trust funds are sub-accounts within the federal accounting and budget systems. Trust funds are budget accounts that are

used to record receipts and expenditures earmarked for specific purposes and designated as trust funds by law.[13] The Department of the Treasury has permanent authority to make Social Security benefit payments when there is a fund balance sufficient to make those payments. As a result, benefit payments do not require annual appropriations from Congress. The trust funds also provide a contingency reserve to help ensure that short-term economic downturns do not result in funding shortfalls.

The Social Security trust funds are not included in the measure of the federal budget that is known as the "on-budget" deficit. However, the trust fund's "off-budget" status does not change the way its year-to-year finances contribute to the government's impact on the economy. Therefore, Social Security is included, along with all other federal programs, in the commonly used unified budget measure. The unified budget measures the government's current incremental borrowing from the public and related draw on financial markets. Social Security's current cash surplus, plus interest earned on treasury securities held by the trust funds, partially offsets the deficit in the rest of the government's accounts. (See table 2 and fig. 5.)

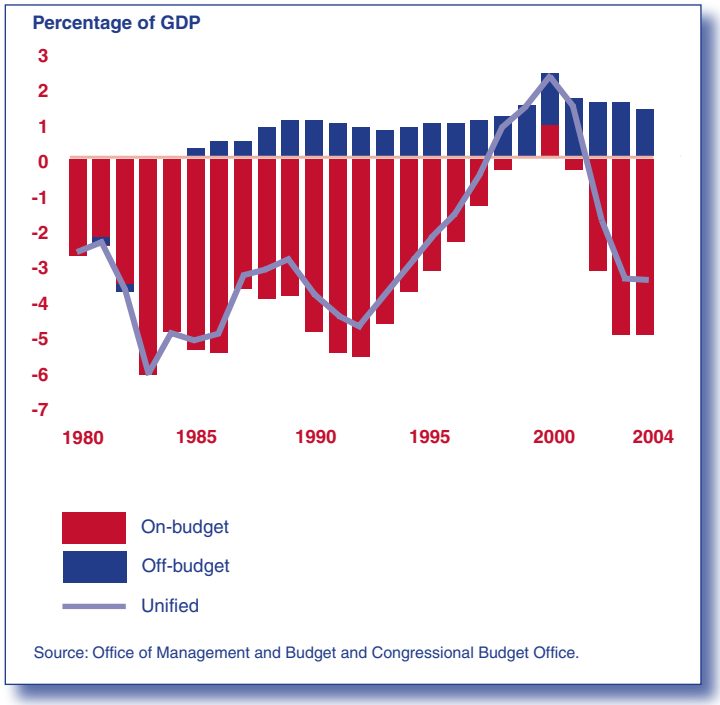
Table 2: Fiscal Year 2004 Deficit Numbers

	Billions of dollars	Percentage of GDP
On-budget deficit	(567)	(4.9)
Off-budget surplus	155*	1.3
Unified deficit	(412)	(3.6)

Source: OMB.
[a]This includes the $151 billion Social Security surplus and a $4 billion surplus for the Postal Service.

[13]GAO, *Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions*, GAO-01-199SP (Washington, D.C.: Jan. 2001).

Figure 5: Surplus or Deficit as a Share of GDP, Fiscal Years 1980-2004



17. Do Social Security taxes get spent on other government programs?

Yes. By law, the Social Security trust funds must invest in interest-bearing federal government securities.[14] Treasury then uses the cash to pay for other government expenses. In effect, Treasury uses Social Security's excess revenues to help reduce the amount it must borrow from the public to finance other federal programs. In other words, Social Security's excess revenues help reduce the overall, or unified, federal budget deficit. If Treasury could not borrow from the trust funds, it would have to borrow more in the private capital market and pay such interest in cash to finance current budget policy. However, Treasury still has to pay the trust funds interest on these securities. When Social Security needs to draw on the trust

[14] These securities, while unmarketable, are backed by the full faith and credit of the U.S. government and guaranteed as to both principal and interest.

funds to pay benefits, Treasury provides cash in exchange for redeemed trust fund securities.[15]

18. Aren't the Social Security trust funds like private sector trust funds?

No. Most federal trust funds, including the Social Security trust funds, do not have the fiduciary relationships that characterize private trust funds. Unlike private trust funds, which are managed largely on behalf of the beneficiary, the federal government has much more flexibility and latitude. The Office of Management and Budget (OMB) summarizes the differences between federal and private trust funds as follows:

> "The beneficiary of a private trust owns the trust's income and often its assets. A custodian manages the assets on behalf of the beneficiary according to the stipulations of the trust, which he cannot change unilaterally. In contrast, the Federal Government owns the assets and earnings of most Federal trust funds, and it can unilaterally raise or lower future trust fund collections and payments, or change the purpose for which the collections are used, by changing existing law." [16]

[15]For more detail about the temporary trust fund buildup and how it interacts with the federal budget, see GAO, *Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy,* GAO/AIMD/HEHS-98-74 (Washington, D.C.: Apr. 22, 1998), and GAO, *Social Security Reform: Demographic Trends Underlie Long-Term Financing Shortage,* GAO/T-HEHS-98-43 (Washington, D.C.: Nov. 20, 1997).

[16]OMB, Analytical Perspectives, Chapter 17, "Trust Funds and Federal Funds" (Washington, D.C.: Government Printing Office, February 1998), p. 321.

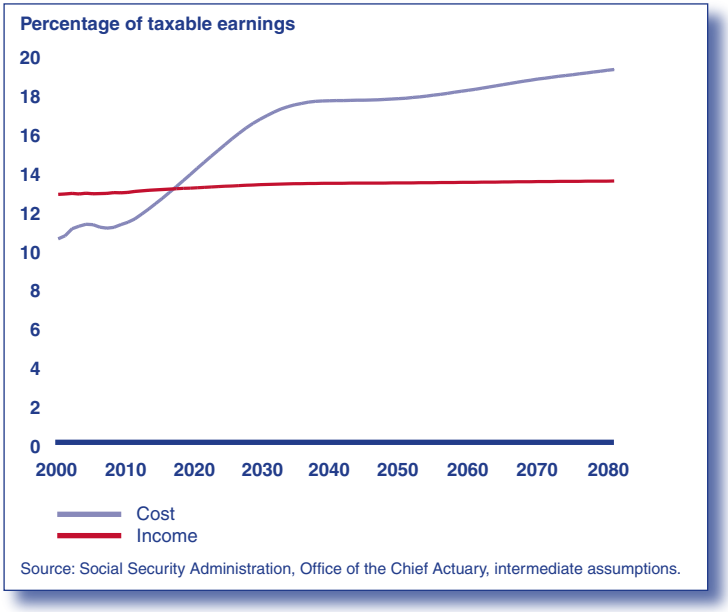
II. Why is there a need for Social Security Reform?

Social Security's Outlook

1. What is the basic problem?

Social Security's benefit costs will soon start to grow rapidly. In 2017, Social Security is projected to pay out more cash in benefits than it receives in revenues.[1] As figure 6 shows, after that time, the gap between costs and income grows continuously, and, unless action is taken to close this gap, the trust funds will eventually be depleted in 2041.

Figure 6: Social Security's Costs Will Exceed its Cash Revenues Beginning in 2017



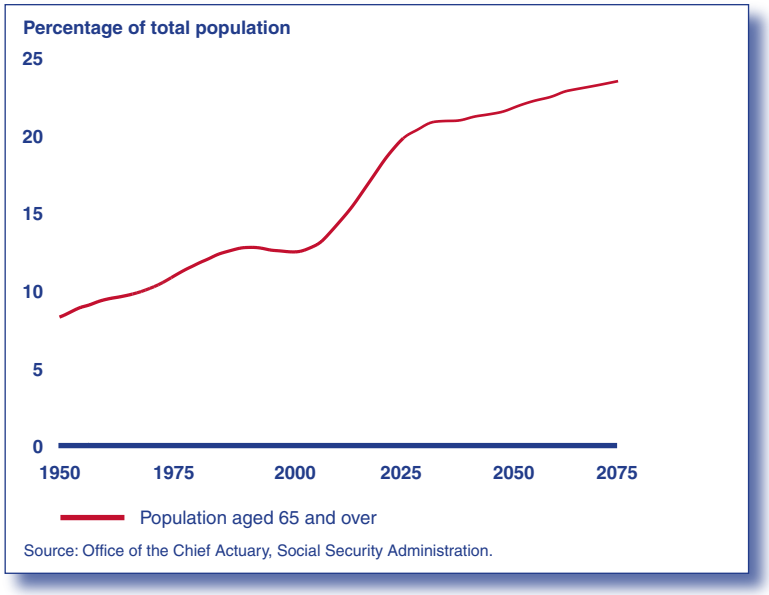
Source: Social Security Administration, Office of the Chief Actuary, intermediate assumptions.

[1] This and all subsequent estimates are from the 2005 Trustees' Report and reflect the intermediate assumptions. Because the future is uncertain, the trustees use three alternative sets of assumptions to show a range of possible outcomes. The intermediate assumptions represent the Social Security Administration's best estimate of the trust funds' future financial outlook. The trustees also present estimates using low cost and high cost sets of assumptions.

2. What are the root causes of this gap between costs and revenues?

Life expectancy has increased continually since the 1930s, and further improvements are expected. As a result of this, along with the aging of the baby boom generation, the aged population is growing dramatically. (See fig. 7.) Today, those aged 65 and over are 12 percent of the population. In 30 years, they will be more than 20 percent of the population.

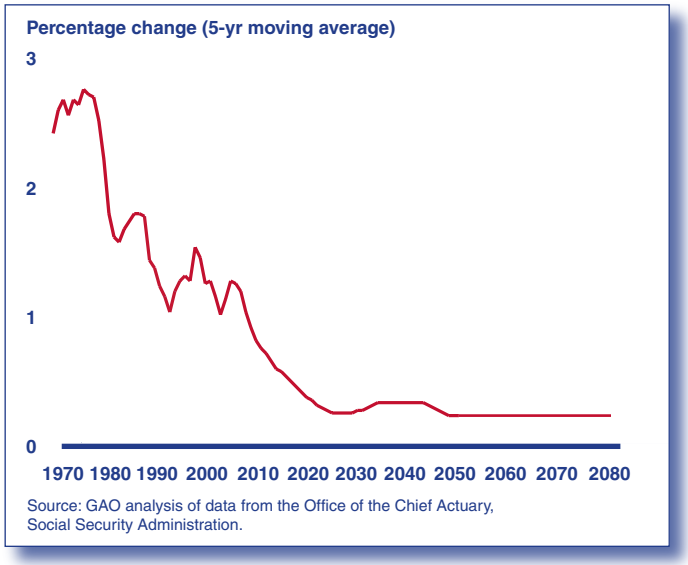
Figure 7: The Aged Are Growing as a Share of the Total Population



Note: Projections based on the intermediate assumptions of the 2005 Trustees' Report.

At the same time, the growth of the labor force is expected to slow dramatically. Fertility rates are falling. The fertility rate is the average number of children born to women during their childbearing years. In the 1960s, the rate was an average of 3 children per woman. Today it is a little over 2 and is expected to fall somewhat further and remain lower than what it takes to maintain a stable population. In addition, the relatively rapid growth of participation in the labor force by older women is expected to slow. Baby boomers will also be leaving the labor force as they retire. By 2025, labor force growth is expected to be less than a third of what it is today. (See fig. 8.)

Figure 8: Labor Force Growth Is Expected to be Negligible by 2050

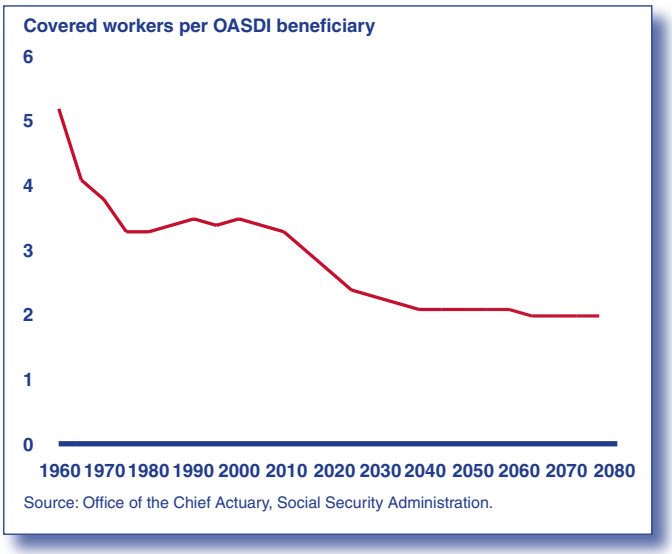


Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

Note: This analysis is based on the intermediate assumptions of the 2005 Social Security trustees' report. The percentage change is calculated as a centered 5-year moving average.

As a result of the aging population and the slower labor force growth, fewer workers will be contributing to Social Security for each aged, disabled, dependent, or surviving beneficiary. While 3.3 workers support each Social Security beneficiary today, only 2 workers are expected to be supporting each beneficiary by 2040. (See fig. 9.)

Figure 9: Social Security Workers per Beneficiary



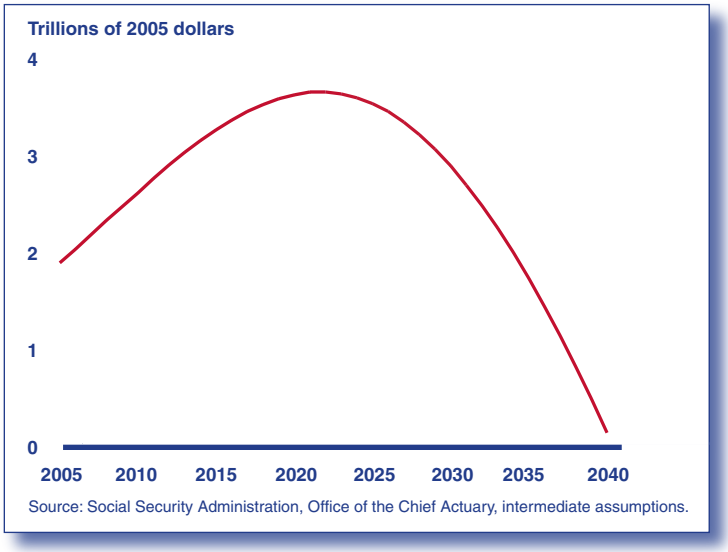
Note: This is based on the intermediate assumptions of the 2005 Social Security Trustees' Report.

3. When does the money run out?

The Social Security trust funds are projected to be able to pay full benefits until 2041.[2] Today baby boomers are still all of working age, and annual Social Security trust fund income exceeds benefit payments. This annual cash surplus is expected to continue until 2017 and help build up the trust fund balances. After that time, annual benefit payments are expected to exceed income, but interest income will more than make up the difference. (See fig. 10.) Beginning in 2027,Trust fund balances are expected to then decline rapidly until they are exhausted in 2041. At that time, annual income will only be sufficient to pay about 74 percent of promised benefits. By 2079, income will only be sufficient to pay about 68 percent of promised benefits.

[2]The Congressional Budget Office (CBO) projects that the Social Security trust funds will be able to pay full benefits until 2052. The differences between the CBO and the Social Security trustees' estimates reflect differences in both economic assumptions and projection methodology. The CBO methodology uses a different approach for capturing and describing the uncertainty of future outcomes. However, both the CBO and the trustees' projections point to the same conclusion: that future Social Security deficits will be large and growing over the long term. See Congressional Budget Office, *The Outlook for Social Security.* Washington, D.C., June 2004.

Figure 10: Social Security's Trust Fund Balance Grows but then Declines Rapidly after 2027



Source: Social Security Administration, Office of the Chief Actuary, intermediate assumptions.

4. How big is the funding gap in dollars?

Actuaries have a variety of ways of answering this question. One approach gives an answer of $4 trillion, another approach gives an answer of $11.1 trillion, and yet a third approach gives an answer of $12 trillion, each in net present value. What's the difference? The estimate of $4 trillion represents the additional amount needed today, which along with the program's annual tax revenues and earnings on the trust fund balances would suffice to pay all the projected annual costs over the next 75 years.[3] This is how much it would cost in 2005 dollars to restore 75-year solvency. This approach to measuring the funding gap reflects the adequacy of financing for a pay-as-you-go system. The estimate of $11.1 trillion represents the same difference between costs and income, except over an infinite time horizon.[4]

The estimate of $12 trillion reflects a change from the current pay-as-you-go system to a system that is fully advance funded. This figure is the additional amount needed today, which along with lifetime payroll tax contributions and earnings on the trust fund balances would suffice to pay

[3] Actuaries call this the open-group unfunded obligation.

[4] Significant uncertainty surrounds any long-term projection. Therefore, the focus should not be on the estimate itself, but rather what the estimates can achieve in terms of solvency.

benefits for all those who are already participants in 2005.[5] By "participants" we include all those who are 15 or older and, thus, have already contributed to the system as of 2005 but exclude any future workers and beneficiaries who have not yet contributed. For a fully advance funded program, this value would equal zero.

In other words, $12 trillion is the value of benefits that past and current participants will receive that exceeds what they will have paid for. It largely reflects the large transfers already made to earlier generations in the start up phase of a pay-as-you-go system. By its nature, a pay-as-you-go system will always have a large unfunded obligation. However, in a pay-as-you-go system, to the extent that future generations are willing and able to pay more in taxes, this unfunded liability can be rolled over from generation to generation indefinitely.

5. Which horizon should we be looking at: 75 years or an infinite horizon?

Both. Each horizon is helpful, providing useful but different information. However, a horizon is not as important to focus on as the concept of sustainability, and on this point each horizon leads to the same conclusion. As figure 6 shows, the gap between costs and income continues to widen through the end of the 75-year period. As each year passes, another deficit year gets factored into the solvency estimate and makes it worse. So even if we restored solvency over the next 75 years, we would only face another 75-year deficit next year. Sustainable solvency would require finding a solution that would eliminate the gap between costs and income on a continuing basis beyond the 75-year period. Using an infinite horizon is one way to look at sustainability beyond the 75-year period. Another way to look at sustainability would be to examine the trend in costs versus income beyond the 75 years. Still another way would be to examine the share of the budget and the economy that Social Security consumes.

Historically, the question of the appropriate time horizon has shifted back and forth. The 1965 Advisory Council on Social Security criticized previous efforts to use an infinite horizon, saying that it "serves no useful purpose;" it suggested using the current 75-year horizon. In contrast, the 2003

[5] Actuaries call this the closed-group unfunded obligation.

Technical Panel on Assumptions and Methods endorsed using the infinite horizon in addition to the 75-year horizon. Still, the panel advised that the methodologies for the infinite horizon needed to be carefully examined.[6] The technical panel further indicated that, referring to estimates from the 2003 trustees' report, the $10.5 trillion estimate is a "large figure" but that it needed to be seen in the context of the present value of taxable payroll over the infinite horizon, which is on the order of $275 trillion. The panel also believed that infinite horizon projections should emphasize the measure as a percentage of taxable payroll.[7]

According to the 2005 trustees' report, over the 75-year horizon the unfunded obligation equals 1.8 percent of taxable payroll, while over an infinite horizon it equals 3.5 percent of taxable payroll. In other words, an immediate increase in the payroll tax of 1.8 percent would restore solvency over the next 75 years, while an immediate increase of 3.5 percent would restore solvency over an infinite horizon, given current assumptions.

No matter which horizon you use or how you look at sustainability, it is important to keep in mind that estimating future outcomes is inherently difficult, and using different assumptions can dramatically alter the estimates. Therefore, in evaluating Social Security reform proposals, it is helpful to focus on the differences between the proposals rather than on the precise values of the estimates for any one scenario. Focusing on the differences helps neutralize the limitations of the assumptions used.

6. Are there any issues other than solvency that call for reform?

In recent years, reform proposals have contained a variety of provisions to address concerns other than restoring long-term solvency. Such concerns include

- mitigating persistent poverty among very elderly widows and those with low lifetime earnings;
- making Social Security coverage universal, that is, covering

[6]Technical Panel on Assumptions and Methods (2003). *Report to the Social Security Advisory Board.* Washington, D.C., October 2003, pp. 84-85. This marked a change from the 1965 Advisory Council on Social Security, which rejected the issue of an infinite horizon in formulating projections. See Advisory Council on Social Security, The Status of the Social Security Program and Recommendations for Its Improvement, Washington D.C. 1965 at http://www.ssa.gov/history/reports/65council/65part1.html.

[7]Technical Panel on Assumptions and Methods (2003). *Report to the Social Security Advisory Board*. Washington, D.C., October 2003, pp. 87-88.

jobs that are not currently covered, such as some state and local government jobs; and

- redressing the effects of increasing earnings inequality on the program's distributional outcomes.

Overall Fiscal and Economic Outlook

7. When Social Security's benefit payments exceed its income, where will the money come from?

Absent other changes, benefit costs will exceed income in 2017. The trust funds will have large reserves, plus interest income on these reserves, to help pay benefits, but benefits must be paid in cash, not in government securities. Starting in 2017, the Treasury Department will begin to redeem trust fund securities in order to continue to pay full promised benefits. Specifically, in order to convert the Trust Fund securities into cash, the government will require increased government revenue, increased borrowing from the public, or reduced spending in the rest of the government.[8] So, even though the trust funds will be able to pay full Social Security benefits until 2041, redeeming their Treasury securities will have an adverse impact on the federal budget much sooner. In fact, in 2009, Social Security's cash surplus starts to decline. To finance the same level of federal spending as in the previous year, the federal budget will need additional revenues and/or increased borrowing, since Social Security's surplus partially offsets the deficit in the rest of the government's accounts. Assuming no additional revenues or spending cuts, budget deficits for the federal government as a whole will increase.

Ultimately, the critical question is not how much the OASDI trust fund has in assets. Rather, it is whether the government as a whole can afford to pay the benefits in the future, and how those benefits compete with other claims on scarce resources? Furthermore, what is the capacity of the economy and budget to afford the commitment?

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[8]For more detail about the temporary trust fund buildup and how it interacts with the federal budget, see GAO, *Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy*, GAO/AIMD/HEHS-98-74 (Washington, D.C.: Apr. 22, 1998); GAO, *Social Security Reform: Demographic Trends Underlie Long-Term Financing Shortage*, GAO/T-HEHS-98-43 (Washington, D.C.: Nov. 20, 1997).

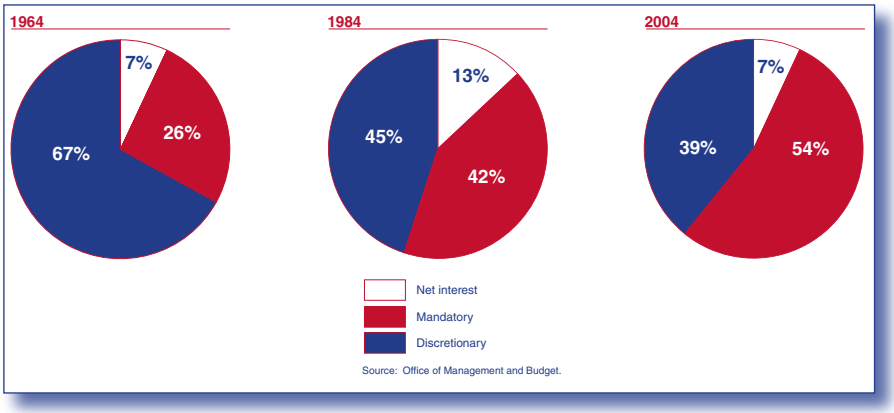
8. What is the outlook for the whole federal budget and its capacity to pay benefits, especially when Medicare and Medicaid are included?

The challenge posed by the growth in Social Security spending becomes even more significant in combination with the more rapid expected growth in Medicare and Medicaid spending. Medicare presents a much greater, more complex, and more urgent fiscal challenge than does Social Security. Medicare growth rates reflect not only a burgeoning beneficiary population but also the escalation of health care costs at rates well exceeding general rates of inflation. For example, increases in the number and quality of health care services have been fueled by the explosive growth of medical technology.[9] This growth in spending on federal entitlements for retirees will become increasingly unsustainable over the long term. The increasing fiscal pressure will reduce budgetary flexibility further. Over the past few decades, spending on mandatory programs—entitlement programs such as Social Security and Medicare—has consumed an increasing share of the federal budget. In 1964, prior to the creation of the Medicare and Medicaid programs, spending for mandatory programs plus net interest accounted for about 33 percent of total federal spending.[10] By 2004, this share had almost doubled to approximately 61 percent of the budget. (See fig. 11.)

[9]GAO has developed a health care framework to help focus attention on this important area and to help educate key policy makers and the public on the current system and related challenges. GAO's health care framework can be found at www.gao.gov/cghome/hccrisis/health.pdf. See also GAO, Comptroller General's Forum on Health Care: Unsustainable Trends Necessitate Comprehensive and Fundamental Reforms to Control Spending and Improve Value, GAO-04-793SP (Washington, D. C.: May 1, 2004).

[10]Net interest is primarily interest on debt held by the public but also includes interest earned from other sources and interest paid for purposes other than borrowing from the public.

Figure 11: Federal Spending for Mandatory and Discretionary Programs, Fiscal Years 1964, 1984, and 2004

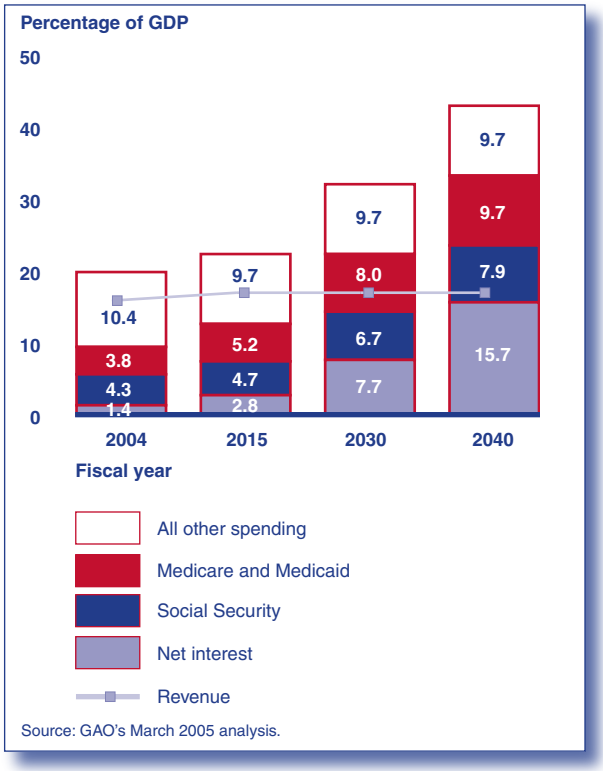


Note: Discretionary programs are those programs controlled by Congress through the annual appropriations process. They include a wide range of program such as defense, environmental, education and other programs.

Moreover, our nation faces growing budget deficits and interest costs. Assuming, for example, that all expiring tax provisions are extended and discretionary spending keeps pace with the economy, by 2040 total federal revenues may be adequate to pay no more than interest on the federal debt. (See fig. 12.) To obtain balance, massive spending cuts, tax increases, or some combination of the two would be necessary. Slowing the growth of discretionary spending and allowing the tax reductions to sunset will not eliminate the imbalance.[11]

[11]For additional discussion of our budget simulations, see GAO, Our Nation's Fiscal Outlook: The Federal Government's Long-Term Budget Imbalance, at http://www.gao.gov/special.pubs/longterm/longterm.html.

Figure 12: Composition of Spending as a Share of GDP, Assuming Discretionary Spending Grows with GDP After 2004 and All Expiring Tax Provisions Are Extended

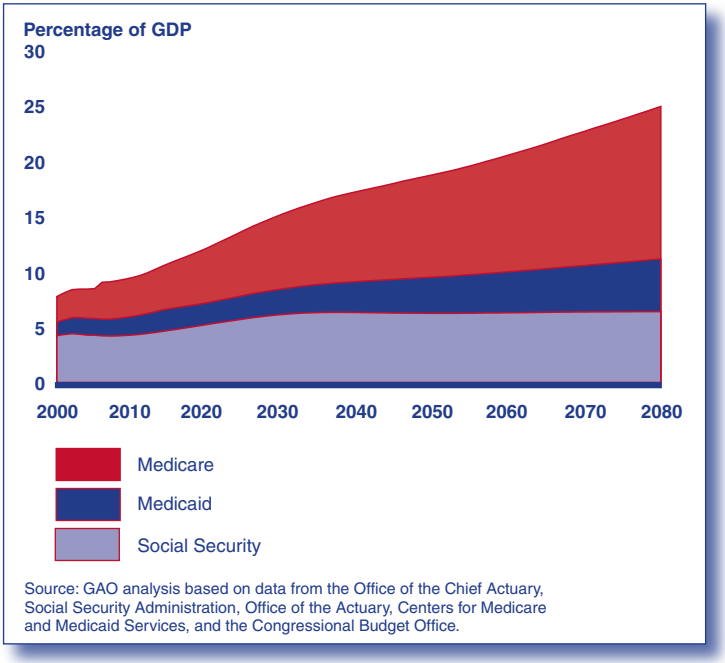


Note: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

9. What are the implications of this budgetary outlook for the economy as a whole?

Figure 13 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2005 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, spending for these entitlement programs combined will grow to 15.2 percent of GDP in 2030 from today's 8.5 percent. Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

Figure 13: Social Security, Medicare, and Medicaid Spending as a Percentage of GDP



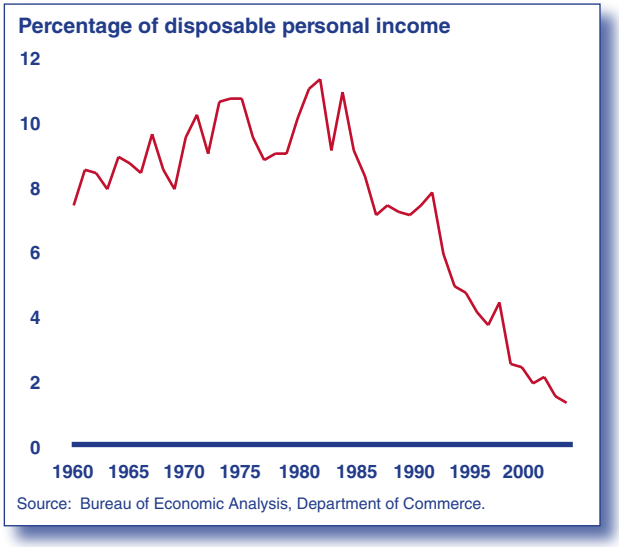
Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

Note: Social Security and Medicare projections are based on the intermediate assumptions of the 2005 trustees' reports. Medicaid projections are based on CBO's January 2005 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under midrange assumptions.

Although higher economic growth could help ease budgetary pressures, the fiscal gap is simply too large for us to grow our way out of the problem. Demographic trends and low national saving rates suggest that higher economic growth, which is fueled by increases in labor, investment, and productivity, will be difficult to achieve. As shown in figure 8 earlier, growth of the labor force is expected to slow dramatically and by 2025 is expected to be less than a third of what it is today.

Increased investment could spur economic growth. However, increasing investment depends, at least in part, on national saving. One component of national saving, personal saving, remains at historically low levels (See Figure 14). Traditionally, the most direct way for the federal government to increase saving has been to reduce the deficit (or run a surplus). Although the government may try to increase personal saving, results of these efforts have been mixed. For example, even with the preferential tax treatment granted since the 1970s to encourage retirement saving, the personal saving rate has steadily declined.

Figure 14: Annual Personal Saving Rates, 1960 - 2004



Consequences of Inaction

10. Why can't we wait for a more immediate solvency crisis to reform Social Security?

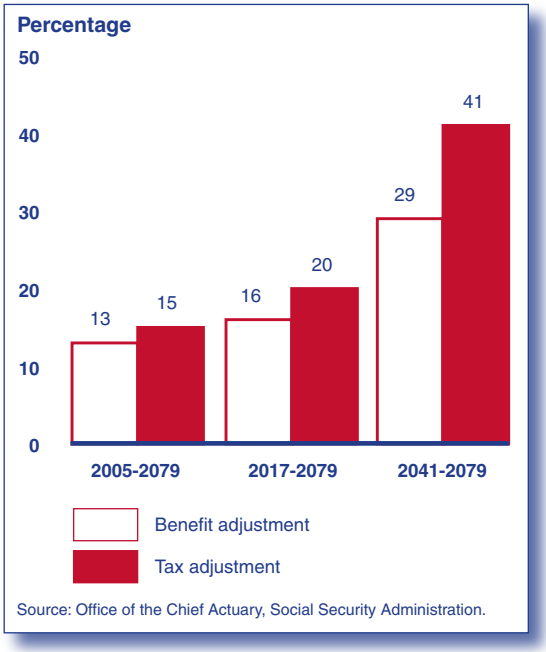
Waiting until Social Security faces an immediate solvency crisis could reduce the options to only those choices that are the most difficult. Acting soon would allow changes to be smaller and to be phased in so the individuals who are most likely to be affected, namely younger and future workers, will have more time to adjust their retirement planning. In addition, acting soon reduces the likelihood that Congress will have to choose between imposing severe benefit cuts and unfairly burdening future generations with the program's rising costs. Taking action soon would also promote increased budgetary flexibility in the future, which could lead to greater investment, productivity, and stronger economic growth. A successful reform effort would improve government credibility and enhance confidence in key financial markets. Even if reforms succeed in increasing national saving, it would take many years for any resulting economic growth to fully develop.

Acting soon would also help to ensure that the "miracle of compounding" works for us rather than against us. Increasing trust fund balances sooner means they have more time to build up with compound interest. Conversely, reducing the publicly held debt reduces the compound interest payments

that taxpayers make on that debt. Some of the benefits of early action—and the costs of delay—can be seen in figure 15. This figure compares what it would take to achieve solvency at different points in time by either raising payroll taxes or reducing benefits.[12] If we did nothing until 2041—the year the Trust Funds are estimated to be exhausted—achieving actuarial balance would require an average reduction in benefits of 29 percent or an increase in taxes of 41 percent, or an equivalent combination of benefit reductions and tax increases for the period 2041-2079. As figure 15 shows, earlier action shrinks the size of the adjustment that would be needed now and in the future.

[12]Solvency could also be achieved through a combination of tax and benefit actions. This would reduce the magnitude of the required change in taxes or benefits compared with changes made exclusively to taxes or benefits as shown in figure 15.

Figure 15: Size of Action Needed to Achieve Social Security Solvency



Note: This is based on the intermediate assumptions of the 2005 Social Security Trustees' Report. The benefit adjustments in this graph represent a one-time, permanent change to all existing and future benefits beginning in the first year indicated.

11. But what happens if we don't do anything?

If we don't do anything, the system will likely become insolvent and pay lower benefits; it will not, though, go bankrupt.[13] However, because the law does not provide for any procedure for paying less than full benefits, it is difficult to say exactly what would unfold. One possible scenario of trust fund exhaustion underscores the need to take action sooner rather than later.[14] Under this scenario, full benefits promised under current law would be paid until trust fund exhaustion. After that date, benefit payments would be adjusted each year to equal annual tax income. Initially, benefits for all Social Security recipients would be reduced across the board to 74 percent

[13]The Social Security Act does not address what would happen if the trust funds become exhausted.

[14]This trust fund exhaustion scenario is intended as an analytic tool, not a legal determination. See GAO, *Social Security Reform: Analysis of a Trust Fund Exhaustion Scenario,* GAO-03-907 (Washington, D.C.: July 29, 2003).

of currently scheduled levels. Additional reductions would need to be taken in successive years; by the end of the 75-year projection period, benefits would be only 68 percent of currently scheduled levels.

This trust fund exhaustion scenario raises significant intergenerational equity issues. Specifically, a much greater burden would be placed on younger generations than under policy scenarios that are phased in over longer periods. Also benefits would be adjusted proportionately for all recipients, increasing the likelihood of hardship for lower-income retirees and the disabled.

A Framework for Evaluation

12. How should we evaluate the various options for Social Security reform?

The Social Security program is so deeply woven into the fabric of our nation that any proposed reform must consider the program in its entirety, rather than one aspect alone. There are many options and trade-offs that need to be considered. Thus, GAO has developed a broad framework for evaluating reform proposals that considers not only solvency but other aspects of the program as well. Specifically, the framework uses three basic criteria:

- the extent to which a proposal achieves sustainable solvency and how it would affect the economy and the federal budget;
- the relative balance struck between the goals of individual equity and income adequacy; and
- how readily a proposal could be implemented, administered, and explained to the public.

The weight that different policy makers may place on different criteria will vary, depending on how they value different attributes. For example, if policy makers determine that offering individual choice and control is a primary concern, then a reform proposal emphasizing individual equity considerations might be preferred. Alternatively, if policymakers determine that benefit certainty and security are of primary concern, then reform proposals that stress adequacy and sustainable solvency might be preferred. As they fashion a comprehensive proposal, however, policy makers will

ultimately have to balance the relative importance they place on each of these criteria.

13. Why do we hear claims about the effects of proposals that directly contradict each other?

In examining the effect of possible reforms to Social Security, many analysts use so-called benchmarks as standards of comparison. For example, discussions of a reform proposal might discuss the size of benefit changes resulting from the reforms. However, calculations of benefit changes use some benchmark that assumes something about what the benefit levels would be in the absence of reform, implicitly or explicitly. Analysts use benchmarks to reflect certain aspects of the existing system that they deem important. Because of Social Security's long-term insolvency, what benefit levels will be in the absence of reform is not at all clear. Revenue increases or benefit reductions, or some combination of the two, will be necessary to restore solvency. Proponents or opponents of a particular reform might well like to calculate benefit changes using a benchmark that is most favorable to their position. So it is possible to have proponents and opponents discussing exactly the same reform proposal but claiming two totally different estimates of what the benefit changes would be. Basing their analyses on different benchmarks would lead to such contradictory results. This can be a source of great confusion.

14. What benchmarks should be used for comparison?

Acknowledging the sensitivity of this issue, GAO evaluations compare proposals to at least two consistent benchmarks that would reflect a solvent system. One benchmark illustrates the most that we would expect benefits to be, while the other illustrates the least that benefits could be. The most that benefits could be would result from restoring solvency by increasing taxes but leaving current benefits untouched. We call these "promised benefits" because they reflect the benefits promised under the existing benefit formula. In contrast, the least that benefits could be would result from restoring solvency only through benefit reductions and leaving taxes untouched. We call these "funded benefits" because they reflect the benefit levels that existing revenues would be able to fund. Still, benefits could be reduced in a variety of ways under such a benchmark.[15]

[15]For more information about the benchmarks, see app. I of GAO, *Social Security: Distribution of Benefits and Taxes Relative to Earnings Level,* GAO-04-747 (Washington, D.C.: June 15, 2004).

In particular, the timing of any policy changes in a benchmark scenario should be consistent with the proposals against which the benchmark is compared. For example, the analysis of most proposals assumes that the proposal is enacted fairly soon, usually within a few years. A benchmark would be consistent with such a proposal if the timing of its policy changes were comparable to the timing of policy changes in the proposal. So, for example, it would not be consistent to compare a proposal that takes effect soon with a benchmark whose policy changes do not take effect for many years.

III. What are the options for Social Security reform?

A wide variety of options for reform have been proposed. In providing an overview of the possibilities for reform, this section attempts to list and describe the range of options individually. However, reform proposals generally package several options together, and the various options can interact with and tend to balance or offset one another. Evaluating complete proposals as packages of various options helps capture such interactions.

Options for reforming Social Security generally fall into three broad groups:

- changing benefits,
- changing revenues, and
- changing the program structure with new individual accounts.

Some of the reform options focus on restoring Social Security's long-term solvency. However, a few aim to enhance benefits for specific groups, such as widows and low earners who are especially at risk of poverty. Often, such enhancements are packaged along with benefit reductions for middle and higher level earners. Also, changing the structure of the program with individual accounts will not, by themselves, achieve solvency. Such approaches generally aim to help move the program toward funding benefit promises in advance and giving individuals the possibility to earn higher returns on their contributions. Since the individual accounts do not result in sustainable solvency, they are often packaged with other benefit reduction or revenue enhancement options that as a package do achieve sustainable solvency.

Changing Benefits

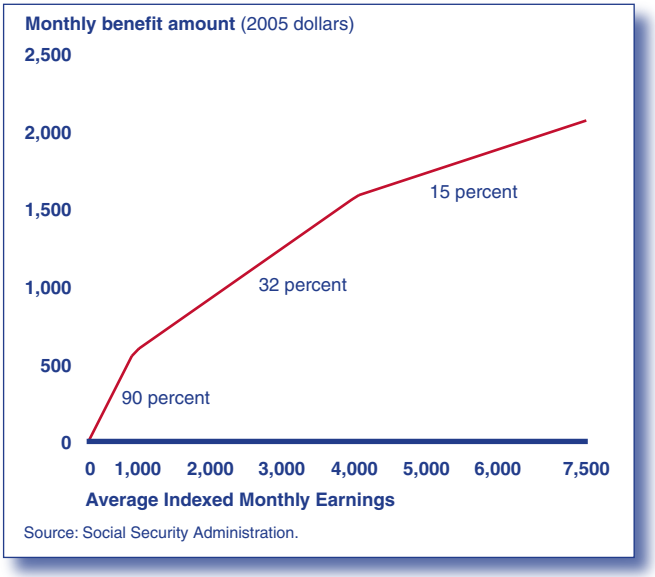
1. What are ways of changing the benefit formula?

As described in section 1, Social Security uses a multifaceted formula to determine initial benefits. This formula can be modified in various ways, either to reduce benefits or to enhance benefits for particular beneficiaries. Such ways include

- *Changing the factors in the formula that determine what percentage*

of each worker's average monthly lifetime earnings are replaced. The current benefit formula replaces 90 percent of average indexed earnings up to a certain dollar threshold, 32 percent of average indexed earnings above that threshold and below a second threshold, and 15 percent of average indexed earnings above the second threshold (see fig. 16). These replacement percentages could be reduced in a variety of amounts and combinations. Also, additional thresholds could be added, and different replacement percentages would apply to the new segments of average earnings that result from the new thresholds.

Figure 16: Social Security Benefit Formula Replaces Earnings at Different Rates



Source: Social Security Administration.

- *Indexing the lifetime earnings used in the formula by prices instead of wages.* Under the current formula, the determination of initial benefits includes a calculation of the worker's total covered earnings received over his or her lifetime, indexed or corrected for the growth in wages over that time period. In the past, wages have grown faster than prices and are expected to continue to be greater than increases in prices in the future as well. Indexing to prices rather than wages, commonly implemented by modifying the replacement percentages, would reduce benefits. In practical terms, doing so would result in a proportional benefit reduction across all earnings levels. However, this could also be formulated in a progressive manner, where only those individuals above a certain income level would be subject to price indexing.

- *Indexing the benefit formula to reflect improvements in longevity.* If people live longer in retirement and collect benefits for more years, the cost of those benefits increases. Indexing the benefit formula to reflect improvements in the average life span of the population could be used to keep the cost of lifetime benefits the same as people live longer. Indexing benefits to such improvements in longevity would be similar to increasing the full retirement age, as workers would have to retire at an older age to get the same benefit as they would under the current full retirement age. In practical terms, modifying the benefit formula in this manner would result in a proportional benefit reduction across all earnings levels.

- *Changing the number of working years over which annual earnings are averaged.* Under the current benefit formula, the calculation of the worker's total covered earnings received over his or her lifetime is based on the highest 35 years of that worker's earnings. Since many workers have earnings in more that 35 years, the current formula permits a higher benefit because workers are able to exclude their lowest earning years from this calculation. Including more of these lower-earning years into the calculation would reduce the average lifetime earnings, which, in turn, would reduce benefits as compared to current levels. On the other hand, decreasing the number of years used in the benefit formula, for example, to exclude years when women are out of the labor force having children, would eliminate additional years in which they had lower or no earnings, and in turn increase benefits for these workers.

- *Modifying factors used to determine benefits for spouses and widow(er)s.* Under the current system, widows or widowers receive benefits that can vary from 50 to 67 percent of the benefit the couples received while both spouses were living, depending on the work records of both spouses. The percentage of the worker's benefit that spouses and widow(er)s receive could be altered to boost the benefits of widow(er)s, who are at especially high risk of poverty.
- *Reintroducing minimum benefit amounts.* Before 1981, Social Security had minimum benefit levels. Some proposals would establish new minimums, for example, for workers who work a certain number of years with earnings greater than or equal to the minimum wage. This would be a benefit increase targeting lower earners, who are at especially high risk of poverty.
- *Modifying adjustments for early or delayed retirement.* Currently, benefits are reduced for workers who retire before the full retirement age and increased for those who retire after that age. These adjustments could be modified to reduce benefits even more for workers who retire before the full retirement age or increase benefits more for those who delay retirement.

2. How could COLAs be reduced?

Each year, monthly benefits being paid out are increased to keep pace with inflation using a cost-of-living adjustment (COLA). The COLA is based on the consumer price index (CPI). Studies have found that the CPI overstates the true rate of inflation, which would make these COLAs higher than necessary to keep pace with inflation.[1] Any such errors in COLAs can be especially expensive since they have a cumulative effect. For the same reason, the effect of changes increases as beneficiaries age. COLA reductions would reduce estimated future benefit costs immediately, and they would affect both current and future beneficiaries. COLAs could also be used simply to reduce benefits, as for example, lowering the COLA to less than the CPI, limiting the COLA to a specified threshold, or delaying the COLA.

[1]For more information on the CPI and how it overstates the true rate of inflation, see Advisory Commission to Study the Consumer Price Index, "Toward a More Accurate Measure of the Cost of Living," Final Report to the Senate Committee on Finance, Dec. 1996; Brent R. Moulton, "Bias in the Consumer Price Index: What Is the Evidence?," Journal of Economic Perspectives, Vol. 10, No. 4, 1996, pp.159-177; Congressional Budget Office, Is the Growth of the CPI a Biased Measure of Changes in the Cost of Living? (Washington, D.C., 1994).

3. How would increasing the retirement age work?

Social Security pays full benefits at the full retirement age. Until recently, the full retirement age was 65. Under reforms enacted in 1983, the full retirement age is gradually increasing to 67. Workers are eligible to start receiving retirement benefits at age 62, but the benefits are reduced because workers retiring early receive their monthly benefits for more years. Workers who retire after the full retirement age receive a credit that increases their monthly benefits because they receive benefits over fewer years.

One option for reform would be to increase the full retirement age further. Doing so has the effect of reducing benefits proportionally across all earnings levels. For any given age at which a worker retires, their benefits will be lower than if the full retirement age had not been increased. However, an increase in the full retirement age could increase disability applications, especially workers in certain occupations (e.g., construction) who may not be able to work longer.

Another option would be to increase the earliest eligibility age. However, if no changes were made to the full retirement age and early retirement adjustments, lifetime benefits for those reaching the new early retirement age would not be affected significantly. Some workers who would have retired before age 65, however, may still qualify for Social Security under the Disability Insurance program.

Changing Revenues

4. What are the options for increasing tax revenues?

There are a variety of options for increasing tax revenues, most of which can be done independently or together as part of a package. These options include:

- *Raising the Social Security payroll tax rate.* Until 1978, raising revenues by increasing the OASDI payroll tax rate paid by workers and their employers occurred quite regularly.[2] The 1977 amendments to the Social Security Act raised the OASDI rate for workers and employers to 6.2 percent, effective in 1990. The

[2]The OASDI tax rate was initially set at 1 percent of the first $3,000 of earnings for both the employee and the employer. The rate increased 20 times between 1937, when the tax was first collected, and 1990, when the rate reached its current level. Higher rates were not needed early in the program, when relatively few of the elderly qualified for benefits. The tax rate increases were always anticipated as part of the maturing of the pay-as-you-go program.

1983 amendments increased the payroll tax rate for the self-employed, raising it to 12.4 percent by 1990. No future increases are scheduled.

- *Raising the cap on taxable earnings.* In 2005, earnings above $90,000 are not subject to payroll taxes. This amount increases each year to keep pace with the growth in average wages. If the cap was raised and the benefit formula remained the same, workers with earnings above the old cap would ultimately receive somewhat higher benefits as well as pay more taxes.

- *Covering all employment.* Today, Social Security covers and collects payroll taxes from about 96 percent of the workforce. The vast majority of the remaining uncovered workers are state, local, and federal government employees.[3] Covering all the remaining workers increases revenues relatively quickly and improves solvency for some time, since most of the newly covered workers would not receive benefits for many years. In the long run, however, benefit payments would increase as the newly covered workers started to collect benefits. Overall, this change would still represent a net gain for solvency, although it would be small.

5. Are there other ways to increase Social Security's revenues?

Social security can obtain revenues from sources currently outside of the program. These include:

- *Transferring revenues from the Treasury's general fund.* General revenue transfers could partially fund the system with money from other government revenue sources. Such transfers would ultimately be financed either by reducing other government spending, increasing taxes, or borrowing from the public.

- *Adding a new revenue stream*. A new revenue source could be earmarked for Social Security, as was done by the 1983 amendments, which extended the income tax to a portion of Social Security benefits for higher income beneficiaries and earmarked the funds for Social Security.

[3] About one-fourth of public employees do not pay Social Security taxes on the earnings from their government jobs. Extending Social Security's coverage to include them could result in potentially significant transition costs for some of their state and local government employers. See GAO, Social Security: Implications of Extending Mandatory Coverage to State and Local Government Employees, GAO/HEHS-98-196 (Washington, D.C.: Aug. 18, 1998).

- *Increasing the investment returns on Social Security holdings.* Currently, by law, the trust funds are invested in Treasury securities that earn a relatively low, safe rate of return. Investing a portion of Social Security trust funds in private sector securities could increase investment returns but also increase investment risk.[4] Under a new system of individual accounts that draw from Social Security contributions, individuals could also invest in the stock market, potentially increasing investment returns while assuming increased investment risk.

Changing the Program's Structure with Individual Accounts

Some reform advocates have suggested the use of individual investment accounts as a component of Social Security reform. Individual accounts are usually associated with two key elements: advance-funding of retirement income through investment in private financial assets, greater individual control of decisions about investing those assets, and individuals assuming the risk associated with such investments. Depending on the proposal, these accounts would replace part of the current Social Security benefit or they would supplement it. A system of individual accounts, especially if they replace a part of the Social Security benefit, would constitute a fundamental change to Social Security and could be significantly larger than any existing retirement investment program. In addition to the question of how to administer and manage the accounts, provisions of individual account proposals can be grouped in three categories corresponding to different phases of the life of the accounts:

- Contribution phase: This includes the decision of whether to participate in the accounts at all, how much is contributed to the accounts, and where the contributions come from.
- Accumulation phase: This includes how account assets are invested and built up and whether the benefits from the accounts are guaranteed to match the current system.
- Distribution phase: This includes how account balances are drawn down and whether funds can be accessed before retirement for any reason.

[4]GAO, Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy, GAO/AIMD/HEHS-98-74 (Washington, D.C.: Apr. 22, 1998).

6. Who would manage the accounts?

A system of individual accounts would require administrative, investment and record-keeping tasks covering all three phases of the life of each account. These tasks could be performed in a system that ranges from very centralized to very decentralized, with varying levels of involvement by government agencies, employers, financial institutions, and individuals. An example of a largely centralized system is the Thrift Savings Plan, which is a retirement savings plan for federal employees, including members of the Congress. An example of a largely decentralized system is the existing system of individual retirement accounts (IRAs), which are tax-deductible individual accounts for individuals.

7. Would accounts be required for Social Security participants?

The first step in the contribution phase of an individual account system would be to determine who participates in the accounts. Some proposals would make participation mandatory, while others would make it voluntary. Voluntary systems further vary depending on whether workers have a one-time choice to participate or can opt in and opt out more than once over their careers. In general, greater choice would involve greater complexity and cost.[5] For example, voluntary plans sometimes offer incentives to participate, while mandatory plans do not need them. Voluntary plans would also require greater educational efforts to help workers make informed choices about choosing whether and to what extent to participate.

8. How much would go into the accounts?

An individual account plan can provide for contributions in a variety of ways. For example, a plan might set contributions at a fixed rate, such as 2 percent of pay, or allow a range of rates up to a certain dollar amount. Some proposals provide for greater average contribution rates for lower earners than for higher earners. For example, contribution rates may go down gradually as earnings rise, or alternatively, all workers might pay a fixed percentage but have a dollar cap on contribution amounts. Also, contributions might be collected and deposited by the government in a centralized process or by employers or account providers in a decentralized process.

[5]GAO, Social Security Reform: Information on Using a Voluntary Approach to Individual Accounts, GAO-03-309 (Washington, D.C.: Mar. 10, 2003).

9. What's the difference between an add-on and a carve-out account?

Individual accounts can either supplement the current Social Security program (add-on) or substitute for all or part of it (carve-out).[6] With add-on accounts, the account and contributions to it have no effect on the Social Security benefit but would require contributions and would offer benefits in addition to the current Social Security program. With carve-out accounts, the Social Security benefit is reduced (or offset) in some way to account for contributions that have been carved out, or diverted, from the current Social Security program. The accounts then offer the potential for making up for or exceeding that offset.

10. What are transition costs?

Under various proposals, contributions to the new accounts could come from either existing payroll tax revenues, increased contribution rates, or general revenue transfers.

In the case of carve-out accounts, however, existing payroll taxes are not adequate to pay for promised Social Security benefits, much less for new account contributions. Making account deposits while also meeting current benefit costs requires additional revenue, which we refer to as transition costs. Depending on the underlying assumptions and the specifics of the proposals, these costs generally range from less than $1 trillion to more than $2 trillion over the next 75 years, in today's dollars. Typically, proposals finance these transition costs with general revenue transfers elsewhere in the budget. In turn, general revenue transfers require decreased government spending, increased revenues, or increased borrowing from the public. Eventually the system becomes stable and there are no more transition costs. However, this could be many years in the future.

Under an add-on account plan, transition costs would not be an issue because no resources are diverted from paying current benefits, though such

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[6]In GAO's work to date, we have used the term "add-on" accounts to refer to accounts that would have no effect on Social Security benefits, would supplement those benefits, and would draw contributions from new revenue streams. In contrast, we have used the term "carve-out" accounts to refer to accounts that would result in some reduction or offset to Social Security benefits because contributions to those accounts would draw on existing Social Security revenues. Others have used these terms in different manners. For example, some have used "add-ons" in connection with new individual accounts funded from new revenue sources that result in a reduction or offset to some or all Social Security benefits. In the final analysis, there are two key dimensions: first, whether individual accounts are funded from existing or new revenue sources; second, whether individual accounts result in some reduction or offset to Social Security benefits.

plans do require additional contributions. These additional contributions could come from an increase in the payroll tax, directly from individuals or from general revenue.

11. What investment options would there be?

With respect to the accumulation phase, individual account plans have provisions regarding the range of investment choices participants have. Some proposals allow individuals wide latitude in investment options; others provide a narrower choice, generally between stock and bond mutual funds, and particular types of mutual funds.[7] For example, the federal government's Thrift Savings Plan permits federal employees to choose among five different investment options, including Treasury bonds, a corporate bond index fund, an equities index fund, an international and small business index options.

12. How would participants draw on the accounts for retirement income?

With respect to the distribution phase, individual account systems generally use three basic ways to pay retirement benefits: annuitization, timed withdrawals, and lump sum payments. Under a system of annuities, retirees would receive monthly payments for an agreed-upon length of time, and the size of those payments would depend on the total value of the individual accounts. Under individual account proposals, annuities would be obtained either through government agencies or the private market. Some proposals would make annuitization mandatory to help ensure that the accounts provided retirement income for the entire remaining lifetimes of participants.

Other options for the payout of accounts include timed withdrawals (also referred to as self-annuitization) and lump sum payments. In a timed withdrawal, retirees specify a withdrawal schedule with the investment manager or record keeper. Each month, they receive their predetermined amount, while the balance of the individual account remains invested. Under a lump sum payment option, individuals may liquidate their accounts through a single payment at retirement and choose to spend or save their money according to their needs or desires.

[7]Mutual funds pool the limited funds of small investors into large amounts, thereby gaining the advantages of large-scale trading. Investors are assigned a prorated share of the total funds according to the size of their investments.

13. Would participants have any guarantee of doing better than under the current system?

To address concerns individuals may have about investment risk, some individual account plans offer guarantees that benefits will reach a certain level. Under a voluntary approach, such guarantees are intended to encourage participation. However, even some mandatory plans have offered guarantees. Guarantees can take a variety of forms. For example, some proposals would guarantee that Social Security beneficiaries would receive total monthly benefits—the traditional benefit plus the account—at least as high as those currently promised.[8] Some other nations with an individual account feature in their national pension systems provide for a more minimal guarantee on their accounts. Germany, for example, requires that account providers return to participants on withdrawal an amount at least equal to the nominal[9] contributions participants made to their accounts.[10]

[8]See GAO, Social Security Reform: Information on the Archer-Shaw Proposal, GAO/AIMD/HEHS-00-56 (Washington, D.C.: Jan. 18, 2000); GAO, Social Security: Reform Proposals Could Have a Variety of Effects on Distribution of Benefits and Payroll Taxes, GAO-04-872T (Washington, D.C.: June 15, 2004).

[9]This amount is not adjusted for inflation; rather it is just the dollar amount the individual contributed.

[10]For more information on the international experience with individual accounts, including Germany, see GAO, Social Security Reform: Information on Using a Voluntary Approach to Individual Accounts, GAO-03-309 (Washington, D.C.: Mar. 10, 2003).

IV. What are the implications of Social Security Reform?

Changing Benefits or Revenue

1. What will achieving sustainable solvency require?

Restoring solvency for the long term requires that either Social Security gets additional income (revenue increases), reduces costs (benefit reductions), or undertakes some combination of the two. The sooner action is taken, the smaller the magnitude of changes that will be necessary to achieve solvency. If changes were enacted today, achieving solvency would require either benefit reductions of 13 percent or tax increases of 15 percent. If no changes were made until 2041—the year the trust funds are estimated to be exhausted—achieving solvency for the period 2041 through 2079 would require reductions in benefits of 29 percent or increases in taxes of 41 percent. Funding the current system of scheduled benefits and taxes over the next 75 years would require $4 trillion today.[1] While it is possible to make the system solvent over a 75-year period, doing so does not solve the problem. It only ensures that projected revenues equal projected outlays over the 75-year period. Solutions that lead to sustainable solvency are those that avoid the need to periodically revisit this difficult issue.[2]

2. What effects do these options have on the overall federal budget and the public debt?

Social Security reforms will affect the amount of cash necessary to pay benefits. These cash requirements ultimately determine the effects on federal budget deficits and the public debt. Regardless of the value of government securities in the trust funds, benefits are paid in cash. When Social Security's cash revenues are not sufficient to pay benefits, the trust funds will exchange government securities for enough cash to cover all promised benefits. Treasury will need to find that cash from decreased spending in the rest of the budget, increased revenues, additional government borrowing from the public, or some combination thereof. Additional government borrowing from the public increases the unified budget deficit and the public debt.[3]

[1] Additional revenue, beyond the $4 trillion, would also be required in order to repay the bonds in the trust funds.

[2] Funding the current system fully forever without cutting benefits or raising taxes would require $11.1 trillion today. However, this would change the financing structure of the system from pay-as-you-go to advance funding.

3. Can Social Security reforms promote economic growth and worker productivity?

As more people live longer in retirement, the costs of providing retirement income will increase unless people retire later or collect smaller benefits. At the same time, relatively fewer workers will be producing the goods and services consumed by all. In the final analysis, no matter what shape Social Security reforms take, those workers will need to be more productive to keep up with the demand for goods and services or we will need more workers. Ideally, Social Security reforms would indirectly promote economic growth and worker productivity, by reducing the strain on the budget. Reduced budgetary pressure could increase national saving and allow greater spending on education, plants, and equipment to make workers more productive.

4. How would benefit reductions affect the adequacy of benefits?

The Social Security program has played an important role in helping ensure adequate incomes for its beneficiaries. One means of addressing Social Security's solvency issue is to reduce benefits from those promised by today's program. Benefits can be reduced in many different ways, but regardless of the approach, benefit reductions will affect the adequacy of benefits. However, certain approaches can have a bigger impact on the adequacy of benefits for particular groups of beneficiaries. For example, some benefit reductions take a proportional approach, reducing benefit formula factors at the same rate across all earnings levels. In contrast, some approaches would reduce benefits less for low earners than for high earners. Also, some proposals enhance benefits for low earners in combination with proportional reductions. The choice of benefit reduction approaches will affect the adequacy of income in the future. A proportional benefit reduction approach would have a greater number of retired workers with benefits below the official poverty threshold than under a non-proportional benefit reduction approach of equal financial magnitude.

The effects of some reform options parallel those of benefit reductions made through the benefit formula. For example, if workers were to retire at a given age, an increase in Social Security's full retirement age would result in a reduction in monthly benefits; moreover, that benefit reduction

[3]The unified budget deficit is the amount by which the government's on-budget and off-budget outlays exceed the sum of its on-budget and off-budget receipts. Public debt is federal debt held by all investors outside of the federal government.

would be a proportional reduction. Another example would be indexing the benefit formula to prices instead of wages, as is currently done, or indexing benefits to future increases in life expectancy. Such changes would also be proportional reductions because all earnings levels would be treated the same under each approach.

A consequence of changing to price indexing could be that Social Security benefits may not keep pace with improvements in the society's standard of living. When wages grow faster than prices, workers can afford to consume more goods and services, their purchasing power increases, and the standard of living improves. Historically, wages have grown faster than prices, on average. Since Social Security's current benefit formula is indexed to wages, increases in initial benefits keep pace with improvements in the standard of living. Indexing benefits to prices instead of wages would make the purchasing power of benefits remain constant even if wage growth were improving purchasing power for the rest of society. In 1960, the standard of living was much lower than it is today. In that year, the average monthly benefit for all retired workers was $74.04. If the average monthly benefit in 2005 were the same, adjusted for inflation, it would be $483.51. If it were adjusted for wage growth instead, the $483.51 would be $676.26 today.

5. Does greater progressivity in benefits imply greater income adequacy?

To help ensure that beneficiaries have adequate incomes, Social Security's benefit formula is designed to be progressive, that is, to provide disproportionately larger benefits, as a percentage of earnings, to lower earners than to higher earners. However, greater progressivity is not the same thing as greater adequacy. Under some reform options, Social Security could distribute benefits more progressively than current law yet provide lower, less adequate benefits.[4] At the same time, reform provisions that favor lower earners can offset other provisions that disfavor them. As a result, any evaluations should consider a proposal's provisions taken together as a whole.

[4]GAO, *Social Security: Distribution of Benefits and Taxes Relative to Earnings Level,* GAO-04-747 (Washington, D.C.: June 15, 2004).

6. What would happen to the adequacy of benefits for the disabled, dependents, and survivors?

Social Security has substantially improved income adequacy for specific subgroups of beneficiaries, such as minorities, women, single persons, widows, and the disabled. However, even with those improvements, significant levels of poverty remain, reflecting the generally lower lifetime earnings and reduced access to other sources of retirement income among such groups. A reform proposal's effect on adequacy for subgroups of beneficiaries will depend on how it changes benefits for these subgroups. Many proposals make changes to the overall benefit structure but do not protect various subgroups. Therefore, a provision that reduces benefits for retirees generally would, in many cases, also reduce benefits for individuals with disabilities. However, the circumstances facing disabled workers differ from those facing retired workers. For example, DI beneficiaries enter the program at younger ages than other beneficiaries and remain in the program in most cases until death. Thus, if the COLA was reduced, disabled beneficiaries could be subject to reductions in benefits for many more years than retirees, due to the cumulative effect of the COLA. Some proposals also include features that might enhance benefits for specific subgroups, such as low-income workers and surviving spouses, which can have substantial improvements on their income adequacy.

7. How will individual equity be affected by these reform options?

The equity perspective focuses on whether, over their lifetimes, beneficiaries can expect to receive a fair return on their contributions; essentially whether or not they get their money's worth from the system. By linking benefits to a worker's earnings through his or her payroll tax contributions, Social Security also incorporates the principle of individual equity. One can assess proposals for their effect on individual equity, although in some cases this can be difficult. For proposals where the financing of the reform is well defined, for example, an increase in the payroll tax, equity can be assessed through looking at measures like the ratio of expected benefits received to expected taxes paid.

In other cases, assessing a proposal for its effect on individual equity can be more difficult, as, for example, when reform options involve general revenue transfers. Such proposals typically do not specify how such transfers are to be financed or who will eventually bear their burden, yet

general revenue transfers implicitly require future tax increases, spending cuts in other parts of the budget, or a combination of both, all of which have substantial distributional consequences. Without knowing who will bear the costs of financing these transfers, the equity perspective cannot accurately determine how well lower earners will fare relative to higher earners in a given system or across proposed reforms.

8. What issues would arise in implementing these options?

Some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security. However, regardless of whether policy makers raise taxes or reduce benefits, or agree upon a combination of these two approaches, how readily the changes can be explained to the public and the amount of time individuals are given to respond to the changes are important issues. A reasonable amount of time will be required for the general public to readily understand the financing and benefit structure of any changes. Individuals may also need time to make adjustments to their retirement decisions based on these changes. For example, individuals may decide they need to work longer, and this decision may necessitate a career change. Therefore, an education effort may be needed in order to increase public confidence and avoid expectations gaps.

Changing the Program's Structure with Individual Accounts

9. Would individual accounts help achieve solvency?

There are many different ways that an individual account system could be set up. However, individual accounts, whether voluntary or mandatory, or whether structured as add-on benefits or as a carve-out from the current system, would generally not by themselves achieve solvency. Achieving solvency requires more revenue, lower benefits, or both. Add-on accounts generally have no effect on the current Social Security benefit or the financing of the system and, thus, have no direct effect on solvency. Because carve out accounts have a negative effect on solvency, as compared with the status quo, most proposals creating such accounts bundle them together with a variety of other reform provisions, and it is the other provisions that reduce benefits or increase revenues that effectively achieve solvency. Thus, the role of individual accounts in reform plans is generally not so much to achieve solvency for the current system as to offer workers an opportunity to make up for the benefit reductions or other changes that are included as

part of the whole proposal. Depending on their design, individual accounts can contribute to sustainability, by providing a mechanism to prefund retirement benefits that would be immune to demographic booms and busts. However, if these accounts are financed through borrowing, prefunding will not be achieved until the additional debt has been repaid, which is likely not to happen for many decades.

10. What would it cost to create a system with individual accounts?

Reform proposals with individual accounts would require substantial additional revenues for a significant period after they are started. This is because existing payroll taxes would be used both to finance the new accounts and to pay benefits. These so-called transition costs are very large; for example, they have been estimated at over $1 trillion for some recent plans over 75 years.[5] A variety of approaches can be used to finance these transition costs, but all involve generating cash revenue to deposit into the accounts. Some proposals fund the transition costs with transfers from the general fund of the Treasury, and such transfers are also known as general revenue transfers. However, these revenues have to come from somewhere, either from reducing other government spending, increasing revenues, borrowing from the public, or some combination thereof.

In the long run, however, the transition costs may be repaid and the net cost of the accounts to the system might be zero, depending on the design of the plan. With carve out individual account proposals, workers choosing to participate in the accounts have their benefits reduced to reflect the value of the contributions made to their accounts. These benefit offsets could be a mechanism to pay back the transition costs eventually, but that cost recovery comes many years after the outflow required for the transition.

11. Aren't these transition costs less than the cost of fixing the current system?

While the previously mentioned transition costs for individual accounts fully fund the accounts, they do not assure solvency of the existing system. In addition to those transition costs, a combination of additional benefit

[5]While this estimate indicates the amount of the transition costs over 75-years, it is important to note that the transition costs may be repaid and part of this repayment may occur beyond the 75-year period. Likewise, if the repayment begins within the 75-year period, this estimate may understate the total transition costs.

reductions or revenue increases would still be required to restore 75-year solvency for the existing system.

12. What effect would individual accounts have on national saving?

The effect that individual accounts have on national saving depends on how the accounts are financed. Individual account proposals that fund accounts through redirection of payroll taxes or general revenue do not increase national saving directly. The redirection of payroll taxes or general revenue reduces government saving by the same amount that the individual accounts increase private saving. Individual accounts financed through a new revenue source, such as increasing payroll taxes, could increase national saving. Beyond these direct effects, the actual net effect of a proposal on national saving is difficult to estimate because of uncertainties in predicting changes in future spending and revenue policies of the government as well as changes in the saving behavior of private households and individuals. For example, the higher deficits that result from redirecting payroll taxes to individual accounts could prompt changes in fiscal policy that reduce spending or increase revenue thereby resulting in lower deficits than would otherwise have been the case and increase net national saving. On the other hand, households may respond by reducing their other saving in response to the creation of individual accounts. No expert consensus exists on how Social Security reform proposals would affect the saving behavior of private households and businesses.

13. How would individual accounts affect the adequacy of benefits?

Individual accounts have the potential for a higher rate of return on contributions than is available in the current system. Along with this potential higher rate of return comes increased risk. Thus, while individual accounts by themselves may improve the adequacy of benefits, it is also possible that individual accounts will worsen the adequacy of benefits. However, since individual accounts do not achieve solvency on their own, they are typically packaged with other options that reduce benefits or increase revenues, and it is these options that achieve solvency. As stated previously, the role of individual accounts in reform proposals is generally to offer workers an opportunity to make up for the benefit reductions or other changes that are included as part of the entire proposal. Therefore, the overall impact that individual accounts have on the adequacy of benefits will depend on the

structure of the accounts, the other changes included in the reform proposal, the choices made by the individual, and the performance of the assets in the account.

14. What effect would individual accounts have on the adequacy of benefits for the disabled, dependents, and survivors?

The effect on adequacy of benefits for subgroups of beneficiaries will depend on factors unique to each subgroup, as well as the structure of the individual accounts. Depending on their design, individual accounts will have a varying effect on the adequacy of benefits for subgroups of beneficiaries. Under some proposals, individual accounts are likely to be a bequeathable asset, which may have a significant effect on the benefits of dependents and survivors. In most cases, disabled beneficiaries leave the workforce sooner than retired workers. With fewer years to make contributions and accrue interest, disabled beneficiaries will likely have smaller account balances. While disabled beneficiaries will still receive a monthly disability benefit, some proposals do not allow access to income from individual accounts until an individual reaches retirement age.

15. What issues would arise in implementing individual accounts?

Regardless of how the individual accounts are structured, how readily the accounts can be implemented, administered, and explained to the public are important issues. Implementation issues that would need to be addressed would include, for example, the management of the information and money flow needed to maintain such a system, the degree of choice and flexibility individuals would have over investment options and access to their accounts, investment education and transitional efforts, and the methods and mechanisms that would be used to pay out benefits upon retirement. These and other changes will require time and funds for implementation in order to achieve reasonable administrative costs. As with any changes to Social Security, individuals may need time to make adjustments to retirement planning. They may also need time to increase their knowledge of investments and risk. Implementing a system that includes individual accounts would also raise a number of issues, such as those regarding the cost of managing accounts and investments, how to manage financial flows, and other issues.

16. What would happen to administrative costs with individual accounts?

The cost of administering a system with individual accounts is likely to be higher than the administrative costs of the current system, and this cost could reduce the amount of savings accumulated in the accounts. However, individual accounts would provide greater individual choice in retirement investments and would carry the potential for a higher rate of return on contributions than is available in the current system. Choices regarding account administration and record keeping will affect program administrative costs. A centralized system would take advantage of economies of scale, which is to say that the more accounts you manage, the lower the cost for each; thus it could have lower administrative costs than a decentralized system, especially considering a number of individuals may initially have small account balances. Administrative costs will also be affected by the amount of choice individuals have in their investments. When a wide range of investment choices is offered, administrative costs are likely to rise. This is especially true if the choices include more actively managed investments. These investments are accompanied by higher management fees because the investment manager spends more time and money on researching, selecting, buying, and selling investments. In addition, systems that offer individuals the option to frequently transfer funds between investments or more choice in payout options can have higher administrative costs. Permitting individuals to choose among several withdrawal options could increase administrative complexity and cost by requiring systems to explain and keep track of the various choices.

17. What tools and educational efforts would workers need to exercise the increased choices associated with individual accounts?

Individual accounts would require a major, ongoing educational effort to help individuals understand the accounts. An essential challenge would be to help people understand the relationship between their individual accounts and traditional Social Security benefits, thereby ensuring that we avoid any gap in expectations about current or future benefits. This challenge is even greater if the individual accounts were voluntary since individuals would need to make informed participation decisions, as well as understand the effect of a benefit offset based on participation. Individuals would also need to be informed enough to make prudent investment decisions, which

would require investor education, especially if individual accounts were mandatory. For example, individuals would need information on basic investment principles, the risks associated with available choices, and the effect of choosing among alternatives offered for annuitizing or otherwise withdrawing or borrowing accumulations from the accounts. This would be especially important for individuals who are unfamiliar with making investment choices.

V. Glossary of Key Terms

Add-On	Individual accounts that would have no effect on Social Security benefits, would supplement those benefits, and would draw contributions from new revenue streams.
Adequacy	(See Income Adequacy.)
Annuity	An insurance product that provides a stream of payments for a pre-established amount of time in return for a premium payment—the amount being converted into any annuity. For example, a life annuity provides payments for as long as the annuitant lives. Only insurance companies can underwrite annuities in the United States. Other financial intermediaries, such as banks and stock brokerage firms, may sell annuities issued by insurance companies.
Average Indexed Monthly Earnings (AIME)	The average monthly earnings received over a worker's career, adjusted yearly by the change in national average earnings. It is the dollar amount used to calculate Social Security benefits for individuals who attain age 62 or become disabled (or die) after 1978. To arrive at the AIME, SSA adjusts a person's actual past earnings using an "average wage index," so he or she does not lose the value of past earnings in relation to more recent earnings. For people who attained age 62 or became disabled (or died) before 1978, SSA uses Average Monthly Earnings (AME).
Baby Boomers	Cohort of Americans born from 1946 through 1964; 76 million strong, they represent the longest sustained population growth in U.S. history.
Baseline	A measurement that serves as a basis against which all following measurements are compared.
Benchmark	A measurement or standard that serves as a point of reference by which process performance is measured.
Carve-Out	Individual accounts that would result in some reduction or offset to Social Security benefits because contributions to those accounts would draw on existing Social Security revenues.
Consumer Price Index (CPI)	A measure of the change over time in the prices, inclusive of sales and excise taxes, paid by urban households for a representative market basket of consumer goods and services. The CPI is prepared by the U. S. Department of Labor and used to compute COLA increases.

Contribution and Benefit Base	The cap on taxable earnings used to fund Social Security. The cap, also called the taxable maximum wage or taxable wage base, limits the earnings that can be used in the benefit formula and, therefore, limits the size of benefits. The cap limits the program's costs and the payroll taxes that pay for them. Limiting the size of benefits reflects the program's role of only providing for a floor of protection. In 2005, the cap is $90,000.
Cost-of-Living Adjustment (COLA)	An increase (or decrease) in wages or benefits according to the rise (or fall) in the cost-of-living as measured by some statistical measure, often the Consumer Price Index (CPI). Social Security benefits and Supplemental Security Income payments are increased each year to keep pace with increases in the cost-of-living (inflation), as measured by the CPI.
Covered Worker	Workers in covered employment, that is, jobs through which the workers have made contributions to Social Security.
Debt Held by the Public	Federal debt held by all investors outside of the federal government, including individuals, corporations, state or local governments, the Federal Reserve banking system, and foreign governments. When debt held by the Federal Reserve is excluded, the remaining amount is referred to as privately held debt.
Deficit	The amount by which the government's spending exceeds its revenues in a given period, usually a fiscal year. The federal deficit is the shortfall created when the federal government spends more in a fiscal year than it receives in revenues. To cover the shortfall, the government sells bonds to the public.
Defined Benefit	A type of retirement plan that guarantees a specified retirement payment at a certain age and after a specified period of service. Defined benefit plans promise their participants a steady retirement income, generally based on years of service, age at retirement, and salary averaged over some number of years. Defined benefit plans express benefits as an annuity, but may offer departing participants the opportunity to receive lump sum distributions. Defined benefit plans are one of two basic types of employer-sponsored pension plans.

Defined Contribution	A type of retirement plan that establishes individual accounts for employees to which the employer, participants, or both make periodic contributions. Defined contribution plan benefits are based on employer and participant contributions to and investment returns (gains and losses) on the individual accounts. Employees bear the investment risk and often control, at least in part, how their individual account assets are invested. Defined contribution plans are one of two basic types of employer-sponsored pension plans.
Dependency Ratio	A rough estimate of the number of dependents per worker; generally defined as the ratio of the elderly (ages 65 and older) plus the young (under age 15) to the population in the working ages (ages 15-64).
Dependent	A person who is eligible for benefits or care because of his or her relationship to an individual. Under the Social Security Act, "dependent" means the same as it does for federal income tax purposes; i.e., someone for whom the individual is entitled to take a deduction on his personal income tax return, generally an individual supported by a tax filer for over half of a calendar year.
Disabled	Disability under Social Security is based on the inability to work. SSA considers a person disabled under Social Security rules if the person cannot do work that he or she did before and SSA decides that the person cannot adjust to other work because of his or her medical condition(s). A person's disability must also last or be expected to last for at least 1 year or to result in death. Social Security program rules assume that working families have access to other resources to provide support during periods of short-term disabilities, including workers' compensation, insurance, savings, and investments. The definition of disability under Social Security is different than under other programs. Social Security pays only for total long-term disability. No benefits are payable for partial disability or for short-term disability.
Dually Entitled	Workers who qualify for Social Security benefits from both their own work and their spouses'. Such workers do not receive both the benefits earned as a worker and the full spousal benefit; rather, the worker receives the higher amount of the two.

Early Retirement Age	The age at which individuals qualify for reduced retirement benefits if they choose to collect benefits before the normal retirement age; the current early retirement age for Social Security is 62. Individuals who choose to take retirement benefits early will have their monthly benefits permanently reduced, based on the number of months they receive checks before they reach full retirement age.
Eligibility	Conditions that must be met for participation. To be eligible for Social Security retirement benefits, everyone born in 1929 or later needs 40 credits. Since a worker can earn 4 credits per year, he or she needs at least 10 years of work that is subject to Social Security to become eligible for Social Security retirement benefits. Each year, the amount of earnings needed for a credit rises as the average earnings levels rise. In 2005, a worker receives 1 credit for each $920 of earnings, up to the maximum of 4 credits per year.
Entitlement	A federal program or provision of law that requires payments to any person or unit of government that meets the eligibility criteria established by law. Social Security, Medicare, Medicaid, and veterans' compensation are examples of entitlement programs. Entitlements leave no discretion with Congress on how much money to appropriate, and some entitlements carry permanent appropriations.
Equity, including Intergenerational	The goal to ensure that the costs and benefits of Social Security bear some relationship to contributions and that a much greater burden is not placed on certain specific groups, including certain generations of workers.
Full Retirement Age (FRA)	(Also called normal retirement age.) The age at which individuals qualify for full, or unreduced, retirement benefits from Social Security and employer-sponsored pension plans. The normal retirement age for Social Security was 65 for many years. Beginning with year 2000 for workers and spouses born 1938 or later and widows/widowers born 1940 or later, the normal retirement age increases gradually from age 65 until it reaches age 67 in the year 2022.
Fully Funded	A system that is fully funded, or "advance funded," is one in which sufficient contributions are put aside each year to pay for future benefits when they come due. Defined contribution pensions and individual retirement accounts are fully funded by definition.

General Revenue Transfers	Funds moved from the General Fund of the Treasury to other programs, sometimes to maintain the solvency of those programs. General funds, constituting about two-thirds of the budget, have no direct link between how they are raised and how they are spent. General fund receipts include income and excise taxes.
Gross Domestic Product (GDP)	A commonly used measure of domestic national income. GDP measures the market value of total output of final goods and services produced within a country's territory, regardless of the ownership of the factors of production involved, i.e., local or foreign, during a given time period, usually a year. Earnings from capital invested abroad (mostly interest and dividend receipts) are not counted, while earnings on capital owned by foreigners but located in the country in question are included. GDP may be expressed in terms of product—consumption, investment, government purchases of goods and services, and net exports—or it may be expressed in terms of income earned-wages, interest, and profits. It is a rough indicator of the economic earnings base from which government draws its revenues.
Hospital Insurance (HI)	Also referred to as Part A of Medicare. HI provides inpatient hospital care, skilled nursing care home health and hospice care subject to a benefit period deductible, and copayments for certain services.
Income Adequacy	In Social Security's history, "adequacy" has never been explicitly defined. However, the Congress expected that Social Security benefits would eventually provide more than a "minimal subsistence" in retirement for full-time, full-career workers. Various measures help examine different aspects of this concept, but no single measure can provide a complete picture. Such measures include poverty rates, replacement rates, and the proportion of the population that depends on others for income support.
Indexation	(See Price Indexation, Wage Indexation.)
Individual Equity	The relationship of benefits to contributions; for example, implicit rates of return on Social Security contributions or money's-worth ratios.

National Saving	Total saving by all sectors of the economy: personal saving, business saving (corporate after-tax profits not paid as dividends), and government saving (the budget surplus or deficit—indicating dissaving—of all government entities). National saving represents all income not consumed, publicly or privately, during a given period. Net national saving is gross national saving less consumption of fixed capital (depreciation).
Off-Budget	Refers to the status of transactions of the government (either federal funds or trust funds) that belong on-budget according to generally accepted budget concepts, but which are required by law to be excluded from the budget. The budget documents routinely report the on-budget and off-budget amounts separately and then add them together to arrive at the consolidated government totals.
Old-Age, Survivors, and Disability Insurance (OASDI)	The two Social Security programs—Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI)—that provide monthly cash benefits to beneficiaries and their dependents when the beneficiaries retire, to beneficiaries' surviving dependents, and to disabled worker beneficiaries and their dependents.
On-Budget	Refers to transactions that are included within the budget.
Pay-As-You-Go	System of financing in which contributions that workers make in a given year fund the payments to beneficiaries in that same year, and the system's trust funds are kept to a relatively small contingency reserve.
Payroll Tax	Tax imposed on some or all of workers' earnings that can be imposed on employers, employees, or both. Payroll taxes are used to finance the Social Security and Medicare programs. Employers and employees each pay Social Security taxes equal to 6.2 percent of all employee earnings up to a cap and pay Medicare taxes of 1.45 percent, with no cap. Payroll taxes are also known as FICA (Federal Insurance Contributions Act) taxes or SECA (Self-Employment Contributions Act), if self-employed.

Poverty	Americans are considered "poor" or "in poverty" if they reside in a household with income below the U.S. poverty threshold, as defined by the U.S. Office of Management and Budget. Poverty thresholds differ by family size and are updated annually for inflation using the Consumer Price Index. Median Social Security benefits have historically been close to the poverty threshold. Social Security has contributed to reducing poverty among the elderly.
Price Indexation	(Compare Wage Indexation.) A method by which benefits are adjusted at periodic intervals by a factor derived from an index of prices; one prominent Social Security reform proposal would price-index earnings to compute benefits, instead of using wage indexing. Over time, increases in wages have been greater and are expected to continue to be greater than increases in prices. Indexing earnings to prices instead of wages would therefore reduce the average lifetime earnings used in the formula, which, in turn, would reduce benefits.
Primary Insurance Amount (PIA)	The monthly amount payable to a retired or disabled worker; it is based on a worker's average indexed monthly earnings.
Progressive	Adjusted so that the rate increases as the amount increases. Describes a tax in which the rich pay a larger fraction of their income than the poor. To help ensure that beneficiaries have adequate incomes, Social Security's benefit formula is designed to be progressive, that is, to provide disproportionately larger benefits, as a percentage of earnings, to lower earners than to higher earners.
Rate of Return	The gain or loss generated from an investment over a specified period of time; also referred to as total return. Calculated as the (value now minus value at time of purchase) divided by value at time of purchase, expressed as a percentage. In the context of Social Security, the implicit rate of return on Social Security contributions would be the constant discount rate that equates the present discounted value of contributions with the present discounted value of benefits.
Replacement Rate	The ratio of retirement benefits (from Social Security or employer-sponsored plans) to pre-retirement earnings. Analysts often compare current benefits to a recipient's previous wages to judge the adequacy of Social Security payments. In the context of Social Security, the implicit rate of return on Social Security contributions would be the constant discount rate that equates the present discounted value of contributions with the present discounted value of benefits.

Social Insurance	Under a social insurance program, the society as a whole insures its members against various risks they all face, and members pay for that insurance at least in part through contributions to the system. Social insurance programs, including Social Security, are designed to achieve certain social goals.
Social Security Administration (SSA)	The federal agency that administers all Social Security-related programs, including the Supplemental Security Income (SSI) and the Disability Insurance (DI) programs.
Solvency	For Social Security, a condition of financial viability in which the program can meet its full financial obligations as they come due. Specifically, the ability to pay full benefits using existing revenue sources and trust fund balances. When a program does not meet these conditions, it is said to be insolvent.
Solvency, Sustainable	For Social Security, to achieve sustainable solvency is to maintain the program's solvency beyond Social Security's Board of Trustees' 75-year forecast and make Social Security permanently solvent. Also defined as having a stable and growing trust fund ratio with program revenues increasing faster than outlays at the end of the 75-year period.
Supplemental Security Income (SSI)	A federal supplemental income program funded by general tax revenues (not Social Security taxes) that helps aged, blind, and disabled people who have little or no income, by providing monthly cash payments to meet basic needs for food, clothing, and shelter.
Supplementary Medical Insurance (SMI)	Medicare SMI, also referred as Part B, is a voluntary insurance program that covers physician services (in or outside of the hospital), outpatient hospital services, ambulatory services, and certain medical supplies and other services, for all persons age 65 or older and persons eligible for Part A because of disability or chronic renal disease.

Survivor (Survivor Benefits)	After a beneficiary's death, Social Security survivor benefits are paid to the beneficiary's survivors, which include • the beneficiary's widow/widower age 60 or older, 50 or older if disabled, or any age if caring for a child under age 16 or who became disabled before age 22; • the beneficiary's children, if they are unmarried and under age 18, under 19 but still in school, or 18 or older but disabled before age 22; • the beneficiary's parents if the beneficiary provided at least one-half of their support. A special one-time lump sum payment of $255 may be made to a spouse or minor children. An ex-spouse could also be eligible for a widow/widower's benefit on the beneficiary's record.
Taxable Maximum Wage	(See Contribution and Benefit Base.)
Taxable Wage Base	(See Contribution and Benefit Base.)
Transition Costs	Refers to the additional revenue required to implement substitute individual account plans. Under some individual account plans, portions of Social Security contributions would be diverted to the accounts. However, under Social Security's pay-as-you-go financing, some of those contributions would also be needed to pay for current benefits. Making account deposits while also meeting current benefit costs requires additional revenue, which we refer to as transition costs.
Trust Fund	An account, designated as a "trust fund" by law, that is credited with income from earmarked collections and charged with certain outlays. Collections may come from the public (for example, from taxes or user charges) or from intrabudgetary transfers. The federal government has more than 150 trust funds. The largest and best-known finance major benefit programs (including Social Security and Medicare) and infrastructure spending (the Highway and the Airport and Airway Trust Funds). These trust funds are essentially sub-accounts of the federal government's accounting and budgeting processes.

Unified Budget	The present form of the budget of the federal government in which receipts and outlays from federal funds and trust funds are consolidated into a single total. The unified budget includes trust fund receipts as income and trust fund payments as expenditures. As a result, any Social Security surpluses serve to reduce the overall, or unified, federal budget deficit.
Wage Indexation	(Compare Price Indexation.) A method by which benefits are adjusted at periodic intervals. Under its current formula, SSA uses the national average wage indexing series to index a person's lifetime earnings when computing that person's Social Security benefits.

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