



Social Security

Why Action Should Be Taken Soon

**Social Security Advisory Board
July 1998**

Social Security Facts

What Do Your Social Security Taxes Pay For?

Workers and their employers each pay 6.2 percent on wages up to \$68,400 into Social Security. These taxes pay for retirement, disability, family benefits, and survivors benefits. Currently 147 million workers (96 percent of all jobs) are covered by Social Security, and nearly 44 million people (one out of every 6 Americans) are receiving benefits.

Social Security Provides:

- Retirement benefits to more than 27 million retired workers. Reduced benefits are payable at age 62; full benefits are payable at 65 (gradually increasing to age 67).
- Disability benefits to nearly 5 million disabled workers with a severe physical or mental impairment that is expected to prevent them from doing “substantial” work for a year or more or who have a condition that is expected to result in death.
- Family benefits to about 3 million spouses and almost 2 million children of retired and disabled workers.
- Survivors benefits to more than 7 million survivors of deceased workers, including nearly 2 million children.

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

What is Social Security’s Current Budget Situation?

- In 1998, income to the Social Security Trust Funds is projected to be over \$484 billion, and outlays \$383 billion, leaving a surplus in 1998 of over \$101 billion. The total amount of the Trust Funds at the end of 1998 is expected to be approximately \$757 billion, which equals about 23 months of Social Security benefits.
- Social Security will account for about 23 percent of total Federal government outlays in 1998, and 25 percent of total Federal government receipts.
- 1998 projected administrative costs for the Social Security programs are \$3.4 billion — less than 1 percent of total Trust Fund outlays.

Social Security Advisory Board

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

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I. INTRODUCTION

The Nation is engaged in an important discussion about the future of Social Security. There are many views about the kinds of changes that should be made. Whatever one's views, essential facts should be agreed upon. The purpose of this paper is to establish two realities that every citizen needs to take account of: (1) the dimensions of the changes that are required if the Social Security system is to maintain solvency beyond 2032, the year the Trust Funds are projected to be exhausted, and (2) the need to make these changes sooner rather than later.

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

Social Security is a social insurance program to which nearly all workers, along with their employers, are required to contribute in order to provide protection against the risk of loss of wages due to retirement, disability, or death of a worker. Retired workers make up 62 percent of all beneficiaries. But the program's income protection extends beyond retired workers. According to estimates, about 4 out of 10 young men, and 3 out of 10 young women, who are now age 20 will die or become disabled before reaching age 67. Today, 10 percent of all Social Security beneficiaries are workers who are disabled and have not reached retirement age; 11 percent are spouses and children of retired and disabled workers; and 16 percent are spouses and children of deceased workers. Whatever changes are enacted, Social Security must continue to protect these vulnerable individuals.

Some think that Social Security should become more of a retirement savings program. They propose that a portion of a worker's earnings be placed in individual investment accounts, either on a mandatory or a voluntary basis. Others believe

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that the program should be maintained largely as it is now, and that solvency should be maintained without making structural changes. (See page 21 for a brief description of some of the proposals that have been made to address the long-range solvency problem.) All of the proposed changes require trade-offs. Evaluating the merits will require careful assessment of their impact on the well-being of individuals and of the society at large.

In considering changes to Social Security, it will also be necessary to take into account the Medicare program. Over the next few years, legislative changes will have to be made to Medicare if the Hospital Insurance Trust Fund is to remain solvent beyond 2008, the year it is projected to be exhausted. Because Social Security and Medicare serve many of the same individuals, and both are financed largely from payroll taxes, they share the challenge of paying for benefits for an increasing number of older persons at the same time that growth in the workforce is slowing. It will be important for policy makers to consider the impact that changes in one program may have on their ability to assure the long-range solvency of the other.

Finally, it is important to recognize that Social Security is only one part of our multi-pillar retirement income system. Social Security has always been intended to provide a foundation for retirement income that needs to be supplemented by individual savings and employer pensions. All parts of this system are in need of review since Americans as a whole are not making adequate provision for their retirement. Social Security reform should be meshed with a strengthening of the other parts of the retirement income system, including employer pensions, individual retirement accounts, 401(k) plans, and other saving mechanisms. Considering Social Security reform within this larger context is a vital aspect of the reform process.

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II. THE LOOMING FINANCING SHORTFALL

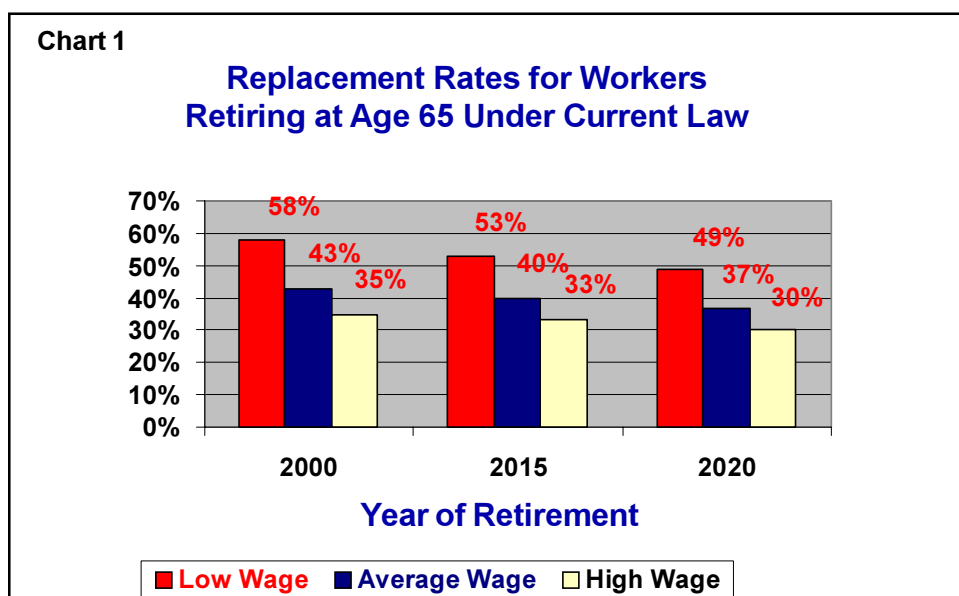
Benefit Levels Under Current Law

The purpose of Social Security retirement benefits is to replace a portion of the earnings that a worker forgoes upon retirement. Reduced benefits may be taken as early as age 62. The age at which individuals may receive full, unreduced benefits is currently set at 65, but this will rise to 67 over the next three decades.

What Retired Workers Receive Now

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

As shown in the chart, the replacement rate for a low wage earner retiring at age 65 in the year 2000 is about 55 percent, and for a relatively high wage worker the replacement rate is about 33 percent.



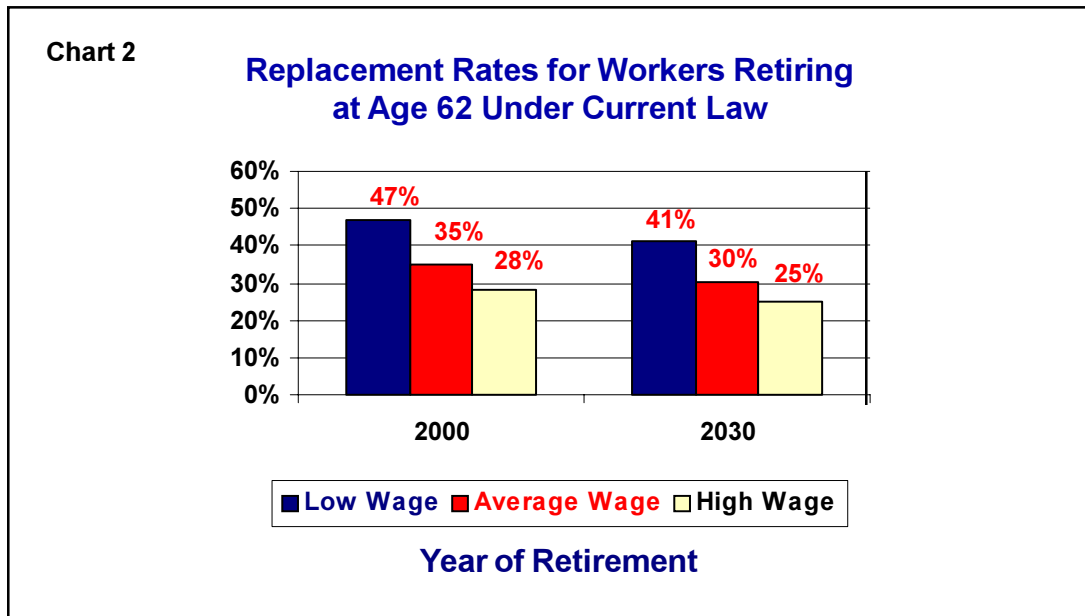
The Effect of the Scheduled Increase in the Retirement Age

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

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

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

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



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

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

Table 1

Estimated Future Annual Benefits Payable to Workers Who Retire at Age 65 At Various Earning Levels (in 1998 dollars)

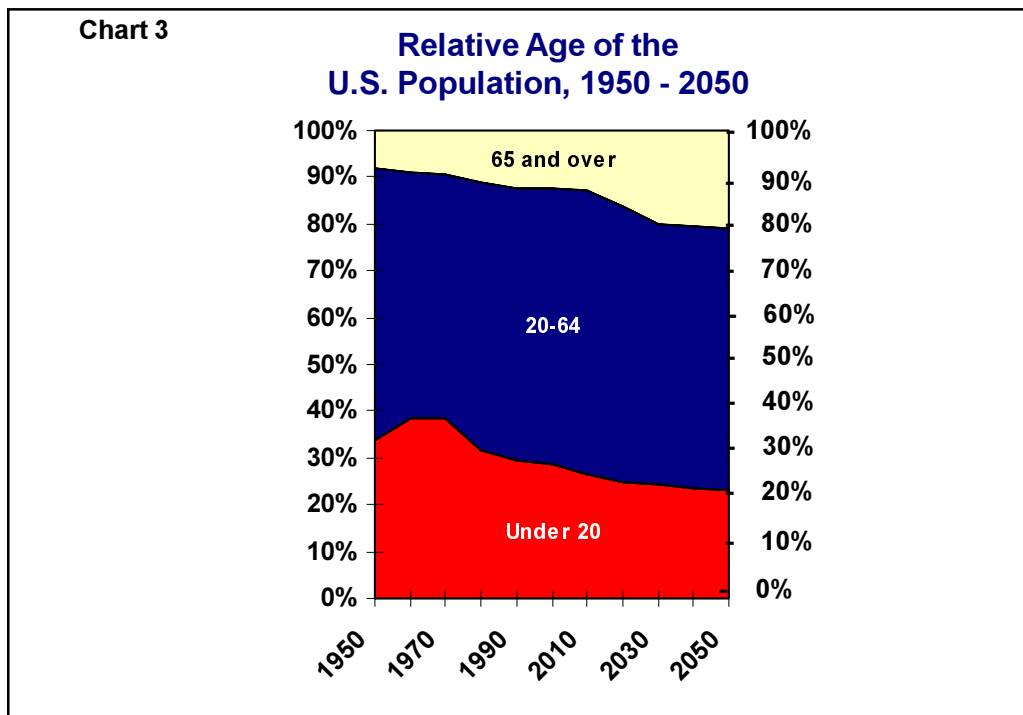
<u>Year</u>	<u>Low Earner</u>	<u>Average Earner</u>	<u>High Earner</u>
2000	\$6,848	\$11,304	\$14,659
2030	\$7,870	\$12,995	\$17,168

What Will Happen When the Baby Boomers Retire?

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

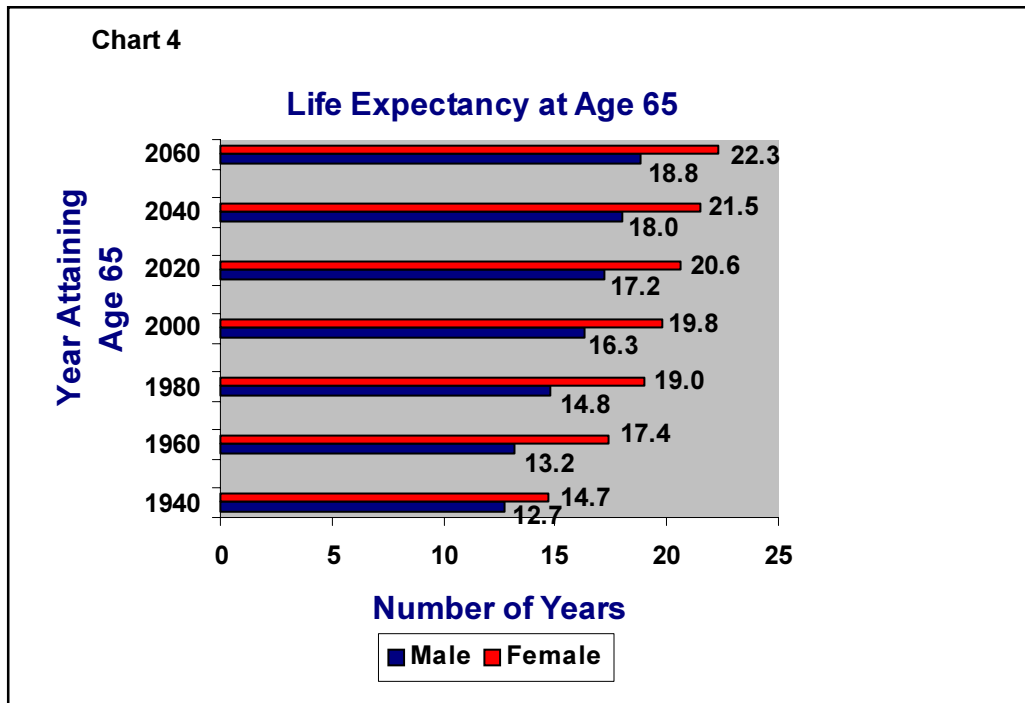
More Retirees

A major shift in the relative size of the working age and elderly populations will begin to occur in the first few years of the next century. The large numbers of people born during the post-World War II “baby boom” currently make up most of the workforce paying Social Security taxes. But they are nearing retirement age, and the oldest of the baby boomers (those born in 1946) will reach age 65 in the year 2011. By 2030, about 20 percent of the population is expected to be 65 or over as compared to about 12 percent in 1990. When the baby boomers move from being taxpayers to being beneficiaries, the cost of the Social Security program will rise quickly.



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



Relatively Fewer Workers

While the growing number of retirees and the increasing duration of retirement will cause spending for Social Security to grow, other factors will cause a slowdown in the growth of the labor force. Projections indicate that the average rate of growth of the labor force will slow from the 2 percent a year it achieved from 1960 through 1989, to 1 percent annually for the years 1990 through 2009, and 0.2 percent for years 2010 through 2050.

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

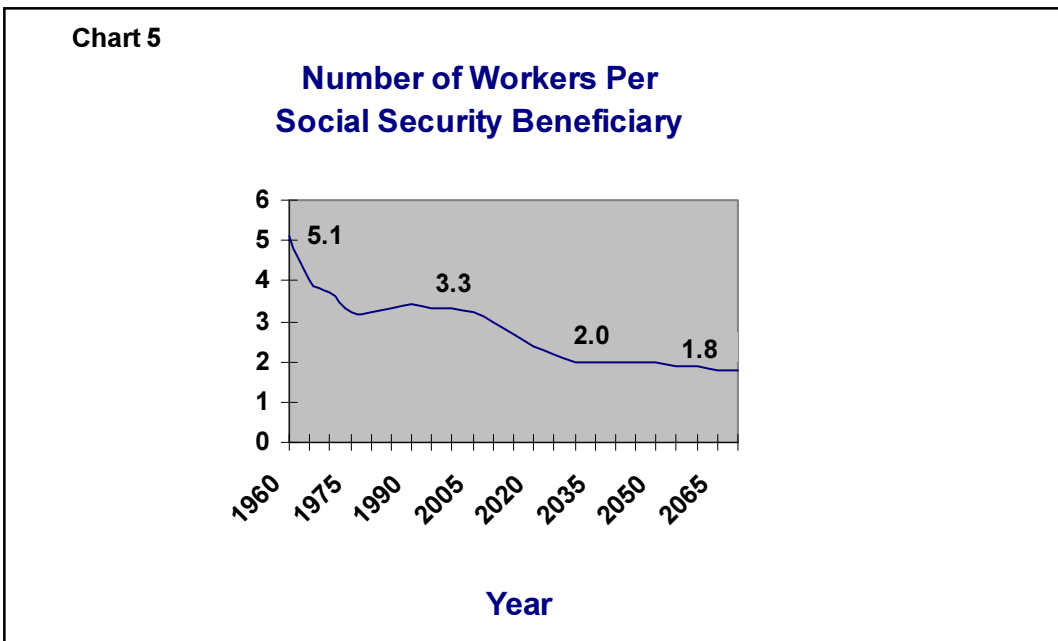
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edged up slightly, to just above 2.00. Over the long run, the actuaries project a fertility rate of about 1.90. Because of lower birth rates, there will be fewer workers to replace the baby boomers as they retire.

Another reason for the slower growth in the number of workers is that the rapid growth in labor force participation by women is expected to level off. The female labor force participation rate increased from 34 percent in 1950 to 60 percent in 1997. Greater labor force participation among women has offset some of the costs of the growing number of Social Security retirees, but this trend must eventually end. Over the long term, female participation rates are expected to increase only slightly above today's level.

Decline in Number of Workers Per Beneficiary

Since most of the money used to pay benefits under the Social Security program comes from the payroll taxes paid by current workers and their employers, the number of workers relative to the number of beneficiaries affects the ability of society to meet obligations to retirees. With more retirees and little growth in the number of workers, the ratio of workers to beneficiaries will decline substantially for several decades. In 1996 there were 3.3 workers for every beneficiary. This ratio will decline to about 2 workers per beneficiary in 2030. Between 2030 and 2050, the number of workers per beneficiary will be relatively stable as the baby boom generation diminishes in size. After the year 2050, this ratio will continue to decline slowly, reflecting the increasing numbers of beneficiaries due to assumed increases in life expectancy.

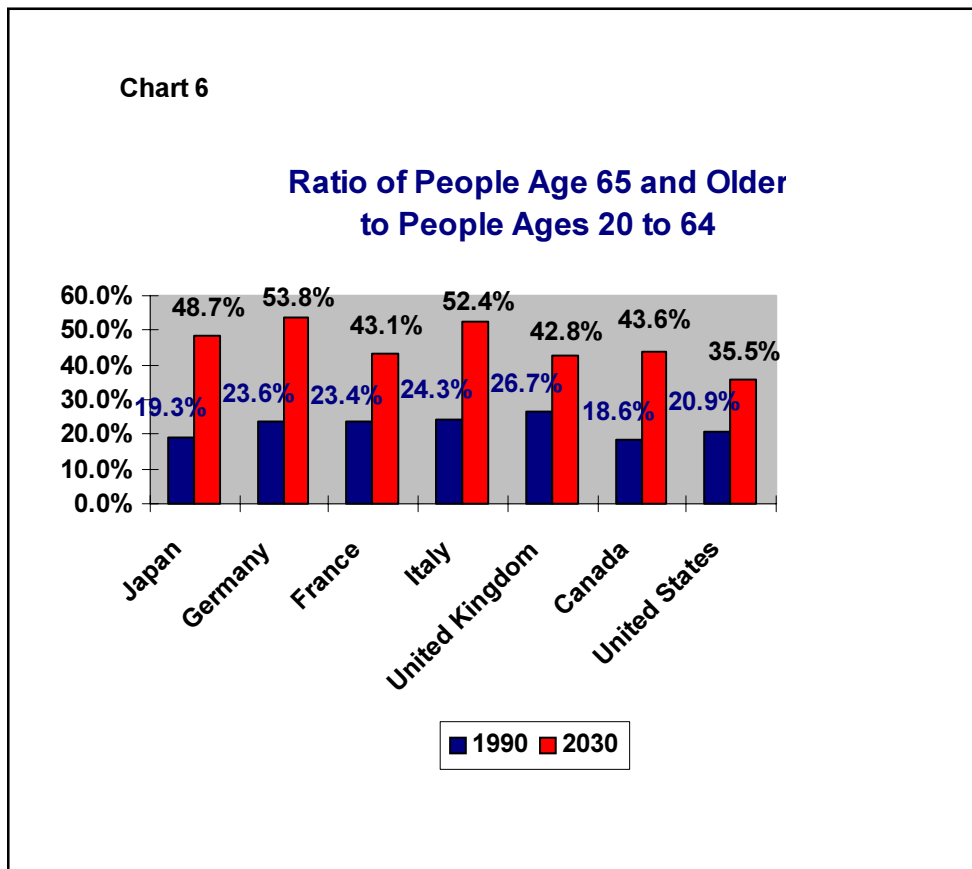


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One of the principal uncertainties for the 21st century is whether the demand for labor in the economy will increase the number of jobs available for older workers and, if so, whether these workers will be willing to postpone retirement and continue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

Experience In Other Countries

The rapid aging of the population over the next few decades is not confined to the United States, but is manifested in countries the world over. In fact, the United States is somewhat better off than other developed countries in this regard. In 1990, in most industrialized countries, the ratio of individuals age 65 and over to the population ages 20 to 64 ranged from about 19 to 27 percent. By 2030, however, the ratios are expected to more than double in Japan, Germany, Italy, and Canada. As Chart 6 shows, in the United States the ratio is projected to grow from nearly 21 percent to nearly 36 percent over this same period of time. Nonetheless, by 2030, the U.S. is expected to have a more favorable worker-to-retiree ratio than any other major industrialized country.

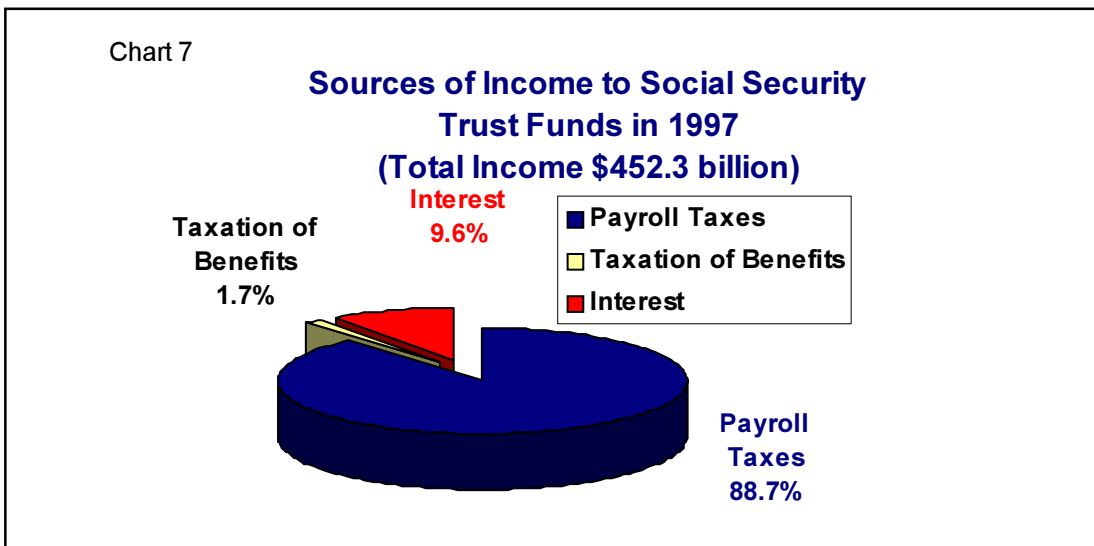


The Status of the Social Security Trust Funds

The Current Situation

In 1998, total income to the Social Security Old-Age, Survivors, and Disability Insurance Trust Funds will exceed spending by more than \$100 billion, and the amount of this excess income is expected to increase over the next 13 years. At the end of 1997, the Trust Funds had assets of about \$655 billion. Assets are expected to grow to almost \$3.8 trillion by 2021. By law, Social Security income that is not needed to pay benefits is invested in U.S. Treasury bonds.

In 1997, payroll taxes accounted for nearly 89 percent of income to Social Security, interest on Trust Fund investments accounted for almost 10 percent, and income from taxes on Social Security benefits accounted for less than 2 percent. (See Chart 7.)



Income from payroll taxes and taxes on benefits is expected to be higher than spending for benefits and administrative expenses until the year 2013. Thus, until 2013 the Social Security program will be a net plus for the Federal budget. This surplus helps to account for the projected surplus in the so-called “unified Federal budget,” which includes the operations of both the general fund of the government and a number of trust funds designated for special purposes, such as the Social Security, Medicare, and Highway Trust Funds. The U.S. Treasury borrows Social Security’s surplus income, uses it for other government activities, and issues bonds to the Social Security Trust Funds.

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Spending Will Exceed Taxes in 2013

Beginning in 2013, Social Security expenditures will be higher than tax income, so that Social Security will become a net cost within the unified Federal budget. At that time, an amount equal to all of the tax income and a part of the interest due to the Trust Funds on outstanding bonds will be needed to pay the benefits that are due. The Federal government will either have to find additional funds elsewhere, or (if the budget is in surplus without considering Social Security tax income, as is currently projected by the Office of Management and Budget) retire less publicly-held debt.

Spending Will Exceed Taxes Plus Interest in 2021

Beginning in 2021, Social Security spending will exceed total Social Security income (taxes plus interest on the bonds). At this point the government will have to begin paying back the funds it has borrowed from Social Security. This will provide the government with a public finance issue that will need to be addressed because, in order to pay the benefits that are due, the Treasury will have to redeem the bonds held by the Trust Funds.

Key Dates for Social Security

2013 - First year expenditures exceed **tax** income; interest on Trust Funds will be needed to pay benefits

2021 - First year expenditures exceed **tax plus interest** income; Trust Fund assets will be needed to pay benefits

2032 - Year program Trust Fund assets are exhausted; Trust Fund income will be sufficient to pay 72% of benefits

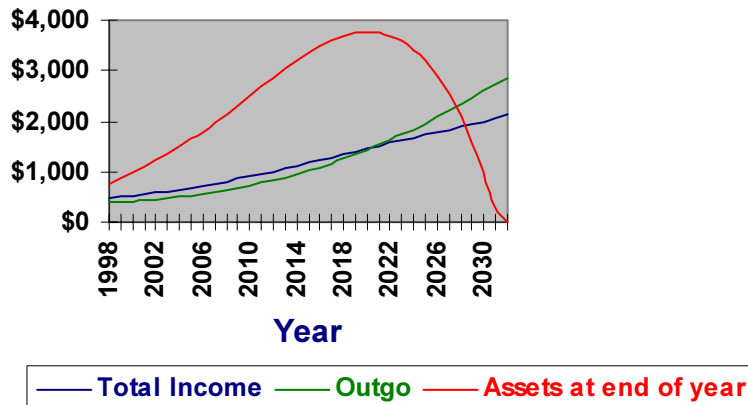
The Situation in 2032

By 2032, income to Social Security will be equal to about three-fourths (72 percent) of the promised benefits. However, the rate of growth in benefit obligations will increase faster than the rate of growth in tax income, so the percentage of the benefits that can be paid with current income will continue to decline, dropping to about two-thirds (67 percent) for the year 2070, and it is expected to continue to fall after that.

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Chart 8

**Social Security Income, Outgo, and Assets
(in billions)**



What Could Happen If No Action Is Taken Before 2032?

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

However, as a way of gauging the significance of the projected financing shortfall, it is useful to look at what could happen in the unlikely event that no action is taken to modify Social Security by 2032 when the Trust Funds are expected to fall to zero. At that point, there would be two basic alternatives — **large benefit cuts or large tax increases.**

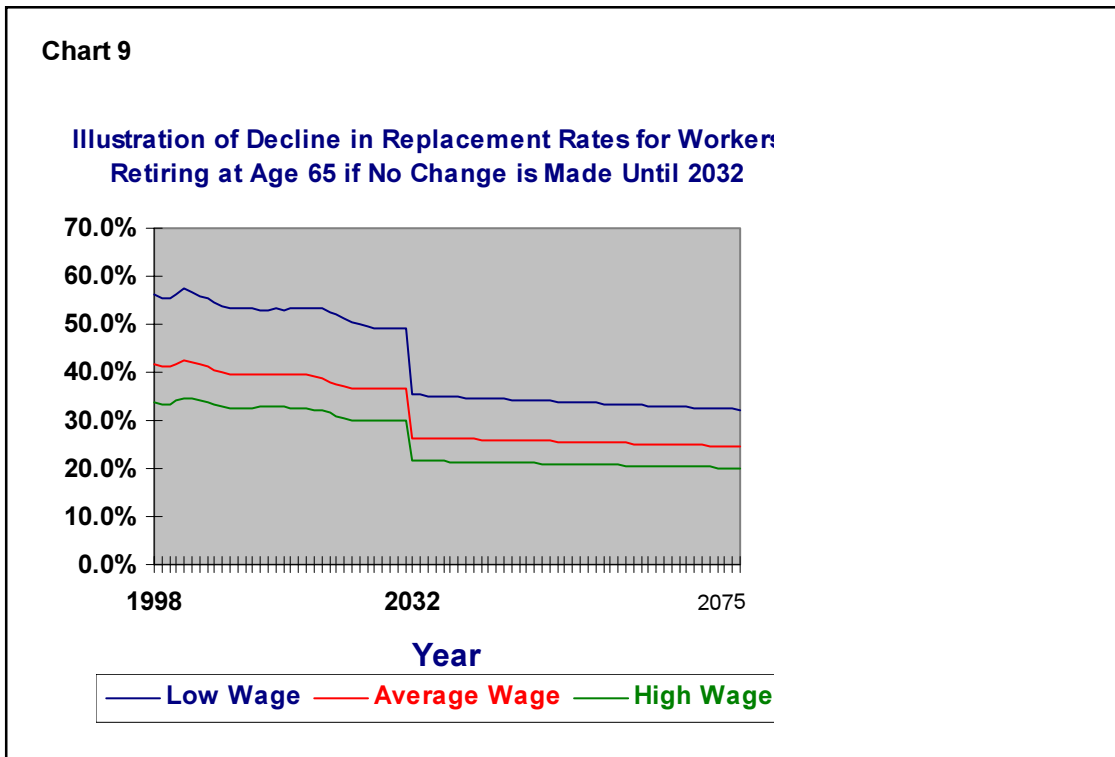
A hypothetical illustration of the impact of cutting benefits

As described above, the Social Security actuaries estimate that in 2032 current income to the system from taxes will be sufficient to pay about three-fourths of the Social Security

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benefits that beneficiaries are entitled to receive under current law. If this situation were met by cutting benefits across the board, there would have to be a 28 percent reduction in 2032 and even larger reductions in later years (ultimately reaching 33 percent in 2070). These reductions would affect both those becoming entitled to Social Security benefits in 2032 and later and those already receiving benefits at that time. To illustrate what it would mean if benefits were cut in this way:

- **The projected average monthly Social Security benefit in 2032 of about \$1,100 (in 1998 dollars) would fall to \$800, and would drop further in later years. Average benefits for low-wage earners would drop from \$670 to \$480.**
- **Initial Social Security benefits awarded to workers who retired in 2032 and after would replace significantly less of these workers’ pre-retirement wages compared to benefits awarded to those who retired in prior years. As illustrated in the chart below, this “replacement rate” for workers who retire at age 65 would immediately fall**
 - **from 49 percent to 36 percent for low earners;**
 - **from 37 percent to 26 percent for average earners; and**
 - **from 30 percent to 22 percent for high earners.**
- **Benefit cuts could mean that, in 2032 and later years, the percentage of aged people living in poverty would rise and that there would be greater reliance on welfare programs, such as the Supplemental Security Income program. Lower benefits would also mean that the standard of living of retirees would fall quickly in 2032 and continue to fall over several decades.**



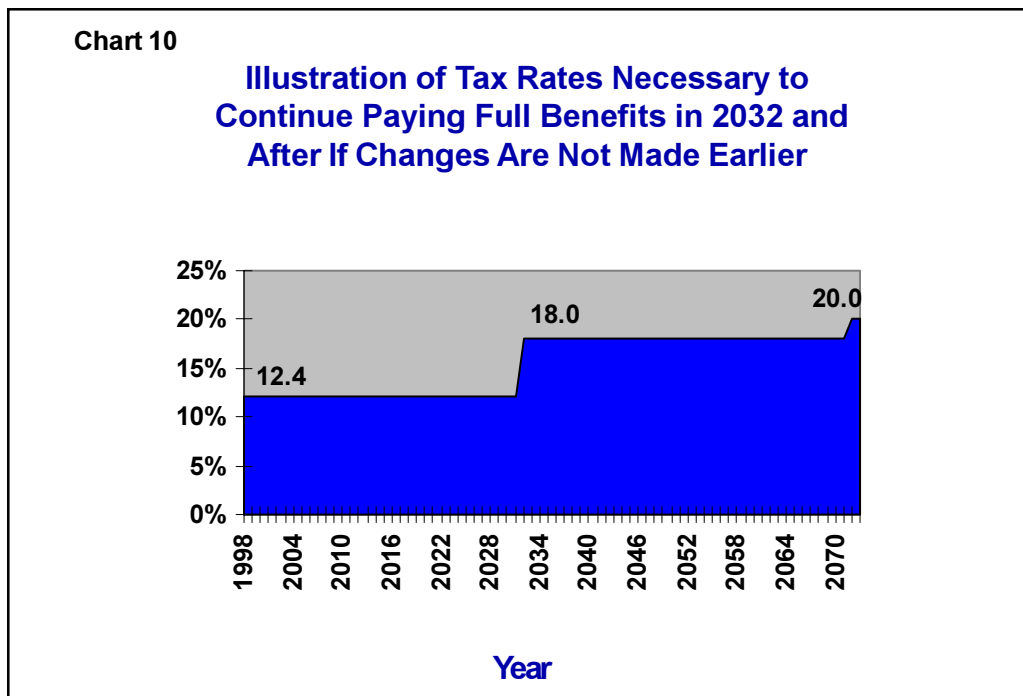
A hypothetical illustration of the impact of raising taxes

In order to continue paying full benefits in 2032 and for about 40 years thereafter, the law would have to be changed to increase Social Security taxes by almost one-half, from the current 12.4 percent (6.2 percent each for employers and employees) to about 18.0 percent (9.0 percent each for employers and employees).

In 2032, for a worker earning the estimated average wage of \$37,625 (in 1998 dollars), this would mean an increase in Social Security taxes of \$1,053 a year (from \$2,333 to \$3,386), levied on both the worker and the worker's employer. For a worker earning the estimated maximum taxable amount of \$91,183 (in 1998 dollars), the increase would be \$2,553 a year (from \$5,653 to \$8,206).

Enacting this higher tax rate around 2032 would not be sufficient to assure that Social Security benefits could be paid for an indefinite period. By 2070, taxes would need to be raised again by about 2 percentage points to keep the system in balance for future decades. (See Chart 10.)

- A tax increase enacted close to the point of Trust Fund exhaustion would have little or no effect on people who have already retired. They would not be subject to the tax for the most part, and their benefits and replacement rates would remain at levels provided in present law.
- However, a tax increase would significantly affect people in the labor force (a group still about twice as large as the retired population in 2032). And the younger the worker when the tax increase takes effect, the larger the impact, as the increased taxes accumulate over a working lifetime.



III. THE ADVANTAGES OF ACTING SOONER RATHER THAN LATER

The Reasons for Prompt Action

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

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

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

- **Confidence in the ability of Social Security to continue to pay benefits to future generations of retirees will be strengthened.** According to a 1996 survey, only 35 percent of those polled were very or somewhat confident in the future financial viability of Social Security. There was a significant difference by age group. For respondents 65 and over the figure was 61 percent. However, for those 30-39 it was only 23 percent, and for those 18-29 it was 33 percent. Fixing the program quickly would eliminate the uncertainty that is currently eroding confidence in the program.
- **There will be less disruption in labor market participation.** Changes in either Social Security benefit levels or tax rates affect the work and retirement decisions of individuals and the hiring decisions of employers. Benefit cuts, for example, would likely induce some people to stay in the labor force longer, while on the other hand, payroll tax increases may cause employers to hire fewer workers and thus limit employment opportunities for older workers. The sooner that both employees and employers know about future changes in Social Security, the more time they have to alter their choices gradually and to avoid creating precipitous shifts in the availability of workers or jobs.
- **There will be less disruption in decisions about consumption and saving.** The Social Security system can affect household decisions about how much to consume and how much to save. Raising tax rates reduces the take-home pay of households and forces people to either consume less, save less, or work more. Reducing expected benefits during retirement years causes people to either save more during their working years or work more to make up for the loss, or to have a reduced standard of living in retirement. The sooner that households become aware of the changes so that they can plan ahead, the smaller would be the disruptions to consumption and saving.

Illustrating the Effects of Acting Sooner Rather Than Later

There are many ways to fix Social Security, and their impact depends on timing. The following illustrates how the effects on both individuals and generations would differ if certain basic changes were effective in 2000 or if they were delayed until 2020.

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

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

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If the COLA were permanently reduced in 2000, Social Security benefits would be lower for everyone getting benefits at that time and for all future beneficiaries. Thus, the many beneficiaries born throughout the 20th century and now in their 60s, 70s, and beyond would share in bearing the cost of fixing Social Security.

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

In 2020, a COLA cut would have to be two-thirds again as large, about 1.6 percentage points, in order to solve the same proportion of Social Security's long-range (75-year) financing problem that a 1 percentage point cut would solve in 2000. A larger cut is needed in 2020 because it applies for fewer years. However, the total program costs over the 75-year period would be the same, no matter when a cut is made.

Because COLA cuts are compounded over time, they have a cumulative effect on benefit levels, which means that they have greater impact on those individuals who live longer and receive benefits over many years. Thus, a 1 percent COLA reduction would reduce a retired worker's benefits below levels provided in current law by about 12 percent when the worker is age 75, and by about 21 percent at age 85.

Reduce the Benefit Formula

The formula used for calculating Social Security benefits in 1998 is 90 percent of the first \$477 of average monthly earnings, 32 percent of the amount above \$477 through \$2,875 of earnings, and 15 percent of additional earnings. The earnings amounts used in the formula are adjusted annually as average earnings in the U.S. economy increase. (The graduated structure of the formula results in more favorable treatment of workers with lower earnings because it replaces a greater percentage of pre-retirement earnings for them than it does for workers with higher earnings.)

One way to reduce program costs is to adjust the Social Security benefit formula for future beneficiaries by lowering the percentage of earnings that is replaced by benefits. A reduction in the current benefit formula beginning in 2000 would lower the percentage of earnings replaced by benefits for everyone eligible to get benefits in that year or later, that is, people born in 1938 and after. It would not affect people born earlier and already eligible for benefits.

In 2020, a COLA cut would have to be two-thirds again as large, about 1.6 percentage points, in order to solve the same proportion of Social Security's long-range (75-year) financing problem that a 1 percentage point cut would solve in 2000.

A reduction in replacement rates of about 5 percent beginning in 2000 would solve 27 percent of the financing problem. If a benefit formula change is delayed until 2020, the ultimate reduction in replacement rates would have to be larger, about 8.5 percent, to have the same impact on the long-range (75-year) program cost. By waiting until 2020, a larger reduction is needed because it applies for fewer years. However, in either case the total program cost would be the same for the 75-year period.

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

Increase the Payroll Tax

Like benefit cuts, the size of the tax increases needed to fix the system would vary depending upon when they became effective. An increase in 2000 of 2.3 percentage points in the current Social Security tax rate, from 12.4 to 14.7 percent (7.35 percent each for employees and employers), would resolve the Social Security funding shortfall until about 2070, when an additional tax rate increase would be needed. If the tax change is not put in place until 2020, the rate needed to resolve the financing problem until 2070 would be an increase of about 4 percentage points, from 12.4 to 16.3 percent (8.15 percent each for employees and employers). By waiting until 2020, a larger increase is needed because it applies for fewer years. In either case, the same total revenue is needed over the period ending 2070.

Tax increases reduce take-home pay for everyone in the workforce at the time they become effective. However, because payroll taxes apply only to earnings below a certain annual limit (\$68,400 in 1998), tax increases have more impact on those workers whose earnings are at or below this limit than on those with higher earnings or with income from sources other than earnings from work.

A reduction in replacement rates of about 5 percent beginning in 2000 would solve 27 percent of the financing problem. If a benefit formula change is delayed until 2020, the ultimate reduction in replacement rates would have to be larger, about 8.5 percent, to have the same impact on the long-range (75-year) program cost.

Increasing Social Security taxes in 2000 would allow the additional costs to be spread over many generations — in rough terms, people born as far back as the late 1930s would pay more. On the other hand, postponing a Social Security tax increase until 2020 would mean that most of the people born before 1958, who would be at or near retirement in that year, would avoid paying any of the additional taxes necessary to pay full benefits to them in retirement.

Establish Individual Investment Accounts

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

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

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

***Increasing Social Security taxes in 2000
would allow the additional costs to be
spread over many generations....***

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

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

During the transition, as the number of retirees under the current Social Security system grows, the burden on current workers would also grow. For example, if nothing is done until 2032 when the Trust Funds are exhausted, it would require a payroll tax of 18 percent (9 percent each for employees and employers) just to pay the following year's Social Security benefits, plus the additional amounts that would be needed to pay for the new system. If changes were made as early as 2000, a payroll tax of about 11 percent (5.5 percent each for employees and employers) would initially be sufficient to pay the next year's benefits, plus the additional amounts needed to pay for the new system.

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

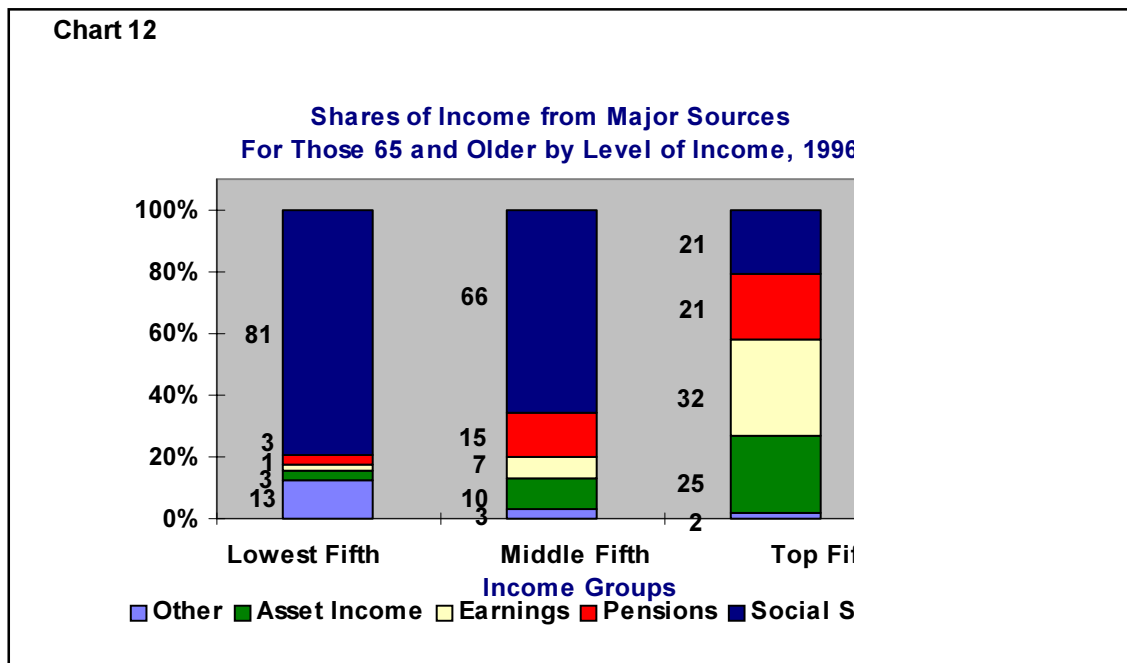
Adopting an individual account plan sooner rather than later would help in addressing transition costs because it could take advantage of the more than adequate financing that Social Security is expected to enjoy through 2012.

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

The Importance of Being Able to Plan For Retirement

Social Security is the major source of income for most of today's retirees, providing 40 percent of the total income to the aged and making up more than half of the income of about two-thirds of the aged. The importance of Social Security and other sources of income differs greatly across income groups. For example, Social Security provides over 80 percent of the total income of the low-income aged (those in the bottom fifth of the income distribution), with public assistance accounting for the next highest portion (11 percent). For 18 percent of beneficiaries, Social Security is their only income.

For the high-income aged (those in the top fifth), earnings are the most important source, amounting to almost one-third of total income. Social Security, pensions, and asset income each account for between 21 percent and 25 percent of income for the high-income aged.



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

The effect of delaying change is to deprive workers unnecessarily of important information upon which they can reasonably base their lifetime plans for retirement security.

BACKGROUND INFORMATION FOR DISCUSSING THE FUTURE OF SOCIAL SECURITY

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

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

According to the actuarial estimates in the 1998 report of Social Security's Board of Trustees, the program faces a long-range shortfall in funding of 2.19 percent of payroll over the 75-year estimating period, equivalent to about \$3 trillion in 1998 dollars. In other words, if the shortfall were to be met only by raising taxes, workers and their employers would each have to contribute 1.1 percent of wages throughout the period. This would be in addition to the 6.2 percent that each is currently paying. Future additional taxes would be required to assure the program's solvency beyond the 75-year time frame.

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

- **Reduce the Social Security cost-of-living adjustment (COLA).** Each year Social Security benefits are increased to reflect increases in the Consumer Price Index (CPI). Many experts believe that the CPI overstates inflation. The size of the overstatement is a subject of dispute. The Bureau of Labor Statistics in the U.S. Department of Labor is changing how it measures the CPI, which will correct at least part of the overstatement.

A reduction in the cost-of-living increase of 1 percentage point below the CPI beginning in 2000 would eliminate about 65 percent of the long-range deficit. A reduction of 0.5 percentage point would eliminate 34 percent.

These changes in the CPI would reduce cost-of-living increases for all individuals who receive benefits after the changes are effective, including both current and future beneficiaries. Because the changes would be cumulative, their effect would grow over time. The impact would increase

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

as people live longer. For example, a 1 percent COLA reduction would reduce a retired worker's benefits below levels provided in current law by about 12 percent when the worker is age 75 and by about 21 percent at age 85.

- **Increase the number of years used in calculating Social Security retirement and survivors benefits.** At the present time benefits are calculated based on a worker's highest 35 years of earnings. A gradual increase of three years (from 35 to 38) would eliminate about 11 percent of the deficit. An increase to 40 years would eliminate 19 percent.

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

- **Modify the formula used to calculate initial benefits to reduce benefits across the board.** An immediate across-the-board benefit reduction of 3 percent would eliminate about 16 percent of the deficit. A reduction of 5 percent would eliminate 27 percent.

This proposal would reduce benefits for individuals who become eligible for benefits after the change becomes effective.

- **Speed up the increase in the "normal retirement age" that will occur under present law; increase it beyond age 67.** Present law provides for phasing in an increase in the normal retirement age from the current age 65, reaching 67 for those who turn that age in 2027. Speeding up this increase so that it is fully in effect for those who turn age 67 in 2016 would eliminate 5 percent of the deficit. Further increasing the age to 68 by indexing at a rate of 1 month every 2 years, reaching 68 for those who turn that age in 2040 (in addition to speeding up the increase to age 67) would eliminate about 18 percent of the deficit. A further increase by indexing to age 70 would eliminate 22 percent.

Increasing the normal retirement age has the effect of reducing the level of benefits for future beneficiaries, particularly those who retire early. However, because life expectancy is increasing, these benefits would, on average, be paid over a longer lifetime.

- **Reduce or eliminate benefits for workers with higher incomes.** The amount of savings from this change would depend on the level at which the income restrictions are applied. For example, reducing benefits by 10 percent beginning at a family income of \$40,000 annually and an additional 10 percent for each additional \$10,000 of income up to a maximum of 85 percent would eliminate about 75 percent of the deficit. Another alternative would be to limit future cost-of-living increases for individuals with higher income.

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

- **Raise Social Security payroll tax rates.** An increase from the current 12.4 percent of taxable earnings (6.2 percent each for workers and their employers) to 14.7 percent in 2000 would eliminate the deficit. An increase in the tax rate to 15.3 percent in 2020 with an additional increase of 2.9 percent in 2050 would also eliminate the deficit.

Increasing payroll tax rates would not affect those already receiving benefits and would have a limited effect on those close to retirement. It would have the greatest effect on young workers and those not yet in the workforce who would pay increased taxes over most or all of their working lifetime. All employers of covered workers would also contribute.

- **Increase the portion of Social Security benefits that is subject to the income tax.** Treating Social Security benefits as taxable income for everyone by eliminating the minimum income thresholds of \$25,000 for a single person and \$32,000 for a couple and putting the additional revenue raised into the Social Security Trust Funds would eliminate about 16 percent of the deficit.

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

- **Increase the amount of earnings subject to the Social Security tax.** In 1998, earnings in employment covered by Social Security that exceed \$68,400 are neither subject to payroll tax nor considered for calculating benefits. This “contribution and benefit base” increases automatically each year with increases in average wages. Currently the base includes 86 percent of all covered earnings, but this percentage has been falling and is expected to continue to fall.

Making all earnings covered by Social Security subject to the payroll tax beginning in 1999, but retaining the current law limit for benefit computations (in effect removing the link between earnings and benefits at higher earnings levels), would eliminate about 91 percent of the deficit. If benefits were to be paid on the additional earnings, 68 percent of the deficit would be eliminated.

Making 90 percent of earnings covered by Social Security subject to the payroll tax and paying benefits on the additional earnings (phasing in these increases in 2001-2003) would eliminate about 25 percent of the deficit. This would increase the estimated maximum amount of earnings subject to Social Security taxes in 2003 to \$123,900, compared to the projected level of \$81,900 under current law.

These changes would cause higher-paid workers and their employers to pay higher taxes. They would mean that higher-paid workers (those above the current taxable maximum) would receive a lower average rate of return on their Social Security taxes than they do today.

- **Extend Social Security coverage to all new employees of State and local governments.** Social Security coverage is virtually universal, with the largest excluded group being employees of a number of State and local governments (those employees who are covered by their own pension system). About 30 percent of all State and local government employees are not now covered by Social Security. A proposal to cover all State and local employees hired after January 1, 2000, would eliminate about 10 percent of the deficit.

The impact of this change would fall on those State and local governments whose employees are currently outside the Social Security system and on all individuals hired by these entities after the effective date of the change.

- **Invest Social Security reserves in the stock market.** The impact on the long-range deficit would depend on the rate of return on stocks relative to Treasury bonds. The real interest rate on

long-term bonds is projected to be about 2.8 percent. By comparison, over the period 1900 to 1995, the real return on investments in stocks has been about 7 percent. If in the future the return on stocks were 4.2 percentage points higher than the rate of return for Treasury bonds, then a 40 percent investment in stocks phased in between 2000 and 2014 would eliminate 46 percent of the deficit. This would reduce the need for future benefit cuts or tax increases to maintain the solvency of the program.

The government would have to find alternative sources of income to replace the funds it currently borrows from the Trust Funds. Also, questions about the government's role in managing investments in the stock market would have to be addressed.

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

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

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

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

- **Use unified budget surpluses to provide individual investment accounts.** Using unified budget surpluses to provide individual accounts would enhance retirement income for current workers. By itself it would not reduce the long-range Social Security deficit. If surplus Social Security revenues are borrowed in order to provide the accounts, additional sources of revenue would have to be found in the future in order to repay the Trust Funds.
- **Return to pay-as-you-go financing.** Setting payroll tax rates at a level sufficient to pay benefits on a current-cost basis (without accumulating more than a minimal reserve) would eliminate the long-range deficit. In the short run, it would result in a payroll tax reduction of about 2 percentage points (1 percent each for employees and employers). One alternative would be to allow workers to invest the amount by which their taxes are reduced in voluntary individual accounts. In the long term, pay-as-you-go financing would increase payroll taxes for both workers and their employers by a total of nearly 5 percentage points as of 2070, unless there were offsetting reductions in benefit costs.

Effect of Proposals to Address the Long-Range Solvency Problem

Options	Savings as % of Taxable Payroll	% of Social Security Deficit Resolved
Reduce the COLA by 0.5 percentage point below CPI, beginning in 2000	0.73	34
Reduce the COLA by 1 percentage point below CPI, beginning in 2000	1.42	65
Increase the number of years used to calculate benefits for retirees and survivors from 35 to 38 (phased in 2000-2002)	0.25	11
Increase the number of years used to calculate benefits for retirees and survivors from 35 to 40 (phased in 2000-2004)	0.42	19
Reduce benefits across the board by 3 percent for those newly eligible for benefits, beginning in 2000	0.36	16
Reduce benefits across the board by 5 percent for those newly eligible for benefits, beginning in 2000	0.59	27
Speed up the phase-in of the currently scheduled increase in the normal retirement age to 67	0.11	5
In addition to speeding up the increase to age 67, index the normal retirement age (by 1 month every 2 years) up to age 68	0.39	18
In addition to speeding up the increase to age 67, index the normal retirement age (by 1 month every 2 years) up to age 70	0.48	22
Reduce benefits by 10 percent beginning at family income of \$40,000 annually and 10 additional percent for each additional \$10,000 (maximum reduction of 85 percent)	1.65	75
Raise payroll tax rates (for employees and employers combined) by 2.3 percentage points in 2000	2.20	100
Raise payroll tax rates (for employees and employers combined) by 2.9 percentage points in 2020 and an additional 2.9 percentage points in 2050	2.19	100

Effect of Proposals to Address the Long-Range Solvency Problem

Options	Savings as % of Taxable Payroll	% of Social Security Deficit Resolved
Eliminate the special income thresholds for taxing Social Security benefits (and put revenue in the Trust Funds)	0.35	16
Make all earnings subject to the payroll tax (but retain the cap for benefit calculations) beginning in 1999	1.99	91
Make all earnings subject to the payroll tax and credit them for benefit purposes beginning in 1999	1.50	68
Make 90 percent of earnings subject to the payroll tax and credit them for benefit purposes (phased in 2001-2003)	0.55	25
Cover all newly hired State and local government employees beginning in 2000	0.21	10
Invest 40 percent of the Trust Funds in stocks (phased in 2000-2014)	1.00	46
Transfer money from general revenues to offset the Trust Fund deficit	Impact on Trust Fund deficit would depend on amount transferred	
Use a portion of the payroll tax (e.g., 2 or 5 per cent) to provide mandatory individual investment accounts	Trust Fund deficit would be increased unless revenue loss is offset by benefit cuts	
Allow or require workers to contribute to individual investment accounts funded by additional amounts withheld from wages	No direct effect on the Trust Fund deficit. Benefits from these accounts would enhance retirement income	
Use the budget surplus to establish individual investment accounts	No direct effect on the Trust Fund deficit. Benefits from these accounts would enhance retirement income	
Return to pay-as-you-go financing and allow workers to put money saved from temporary payroll tax reduction into individual investment accounts	Trust Fund deficit would be eliminated by raising payroll taxes as needed to meet future benefit obligations	

Issues Raised by Proposals to Address the Solvency Problem

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

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

Will benefits be adequate?

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

Will costs and benefits be fair?

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

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

What are the risks?

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

Are benefits progressive?

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

How will the economy be affected?

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

What will be the effect on the Federal budget?

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

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

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

What will be the effect on program efficiency and integrity?

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

What will be the effect on public confidence and understanding?

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

THE SOCIAL SECURITY ADVISORY BOARD

Establishment of the Board

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

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

Board members serve staggered terms. The statute provides that the initial members of the Board serve terms that expire over the course of the first 6-year period. The first two members' terms expired September 30, 1996 and September 30, 1997, respectively. The Board currently has two vacancies.

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

Members of the Board

Stanford G. Ross, Chair

Jo Anne Barnhart

Lori L. Hansen

Martha Keys

Sylvester J. Schieber

GLOSSARY

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

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

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

- ◆ **Low**—Earnings that equal 45 percent of the average wage.
- ◆ **Average**—The average of all wages in the economy (\$26,839 in 1997).
- ◆ **High**—Earnings that equal 160 percent of the average wage.

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

Normal retirement age. The age at which a person can first become entitled to unreduced retirement benefits. Currently age 65, but scheduled under present law to increase gradually, reaching 67 for persons that age in 2027 or later, beginning with an increase to 65 years and 2 months for persons reaching age 65 in 2003 (age 62 in 2000).

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

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

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

Taxation of benefits. During 1984-93, up to one-half of an individual’s or a couple’s Social Security benefits was subject to Federal income taxation under certain circumstances. The revenue derived from this provision was allocated to the Social Security Trust Funds. Beginning in 1994, the maximum portion of Social Security benefits potentially subject to taxation was increased to 85 percent. The additional revenue derived from taxation of benefits in excess of one-half is allocated to the Medicare Hospital Insurance Trust Fund.

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

MAKING ASSUMPTIONS ABOUT THE FUTURE

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

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

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

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

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

The numbers used in this document are derived primarily from information provided by the Office of the Chief Actuary of the Social Security Administration and reflect the intermediate assumptions of the 1998 Report of the Trustees of the Old-Age, Survivors, and Disability Insurance Trust Funds. Information on income of the aged comes from the SSA Office of Research, Evaluation, and Statistics, and data on foreign programs is based on projections by the World Bank.

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