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An Overview of Social Security Reform Proposals

Current Proposals Differ Dramatically, Ranging From Marginal Changes to Eventual Privatization

Introduction

In 1994 the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Trust Funds that finance Social Security predicted that the combined trust funds would run out of money in 2029, seven years sooner than it had estimated in its report of a year earlier. Since then there has been a growing interest in making the changes needed to restore the program's long-term financial balance. Over the past few years a great deal of effort has gone into studying the problem. Within the last year, a number of concrete reform proposals have been put forward by different groups.

A previous report examined the financial pressures facing Social Security and Medicare.[1] This report summarizes the major components of six competing plans. A subsequent report will review the problem facing Social Security in greater detail, analyzing the major issues involved in reform.

A Brief Overview of Social Security's Finances

Although Social Security is currently running surpluses that will average over $30 billion annually during the next decade,[2] all observers agree that the program suffers a long-term financing problem. The main reason for this problem is the upcoming retirement of the Baby Boom generation generally defined as those Americans born between 1947 and 1964. Beginning when the first Baby Boomers retire in 2010, Social Security benefits will grow much more rapidly than payroll receipts, producing annual deficits that accelerate each year. The last Baby Boomers will not retire until 2030 and on average will receive benefits for another 15-20 years. As a result of the Baby Boomers' retirement the ratio between workers and retirees continues to fall so the burden of supporting senior citizens falls on fewer shoulders.

In 1997 almost all workers[3] pay 10.7 percent of their wages up to $65,400 into the Old-Age and Survivors Insurance (OASI) Trust Fund that pays Social Security retirement benefits.[4] They pay an additional 1.7 percent into the Disability Insurance

[1] *Social Security and Medicare*, LAR-375, Manufacturers Alliance, August 23, 1996.

[2] This figure excludes the interest that the government pays on the bonds in the Social Security trust fund. These payments are intergovernmental transfers. Whether or not they should be fully credited to Social Security depends on the extent to which one views Social Security taxes as being in lieu of income taxes or in lieu of contributions to a private savings account. The projection that Social Security will go bankrupt by 2029 assumes that the federal government will continue to make interest payments even when Social Security begins running large annual deficits (projected to be $425 billion by 2025).

[3] A small proportion of state and local employees neither pay Social Security taxes nor receive credit for benefits. Most reform proposals would force these workers into the program.

[4] Half of this tax is withheld directly out of the worker's paycheck. The other half is paid by the employer on the worker's behalf. Economists generally agree that increases in the employer's share are passed on to the workers in the form of lower take-home pay.

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(DI) Trust Fund.[5] In order to balance the combined OASDI funds throughout the next 75 years, the combined tax of 12.4 percent would have to be raised right now by 2.23 percentage points.[6] The timing of the problem becomes clearer if we look at separate 25-year periods. For the next 25 years, 1997-2021, the program is basically in balance. Between 2022-2046, however, the program becomes insolvent with a negative balance equivalent, to 4.33 percent of the payroll. The final period, 2047-2071, is only slightly worse at 5.38 percent of payroll.[7]

All of the proposals discussed below claim to avoid insolvency by achieving savings equal to the stream of revenue generated by an immediate increase of 2.23 percentage points in the payroll tax. They do so in dramatically different ways, and with very different consequences for existing and future workers and retirees, however. Some of the plans go even further and increase tax rates on the presumption of their authors that many workers are not saving enough for their own retirement. In return for higher taxes, each of these plans gives workers greater control over the investment of the additional funds.

How Social Security Benefits Are Calculated

In order to compare the different recommendations for fixing Social Security, it is necessary to understand how the program calculates benefits.

Worker Benefits

Social Security benefits are based on the amount of wages subject to the payroll tax, not on actual taxes paid into the system. Hence older retirees receive full retirement benefits even though payroll taxes were much lower during most of their working years. Similarly, increasing payroll tax rates would not entitle workers to higher benefits when they retire.

The first step in calculating benefits is to compile a history of the wages a worker earned each year, up to the ***maximum amount of taxable earnings*** ($65,400 in 1997[8]). Since wages above this amount are exempt from the payroll tax, they affect neither the amount a person pays into Social Security nor the benefits he receives.

As a next step all wages earned before a person turned 60 are adjusted upward to account for both inflation and real wage growth by multiplying them by an indexing factor equal to the ratio of the average national wage in the year the person turned 60 to the average national wage in the year the income was earned. Wages earned after the age of 60 are not indexed. The 35 years with the highest earnings are then selected and added together. The total is divided by 420 (the number of months in 35 years) to produce a figure called the ***average indexed monthly earnings*** (AIME). As a result of this calculation, people do not receive extra benefits for working more than 35 years, even though they continue paying taxes. Someone nearing retirement does not gain from working another year unless it is one of his 35 highest earning years. Even then, the benefit of adding in the higher year's earnings is partially offset by the taxes paid on the income and the effect of dropping out the earnings for one of the previous years.

The next step is to apply a progressive formula to determine how much of the AIME should be replaced by the monthly Social Security benefit. In 1997 this was done by multiplying the first $455 by 90 percent, multiplying the next $2,286 by 32 percent, and multiplying the remaining amount above $2,741 by 15 percent. The ***replacement ratios*** remain constant from year to year. The ***bend points*** these ratios apply to are indexed to rise annually with average wages and salaries. The total is the worker's initial monthly benefit, the ***Primary Insurance Amount*** (PIA). After the age of 62, a person's PIA is indexed to changes in the Consumer Price Index (CPI).

Although a person is eligible for full benefits when he reaches the ***normal retirement age*** (NRA) of 65, he can retire earlier or later. In either case an actuarial adjustment is made to the monthly benefits so that he receives the same amount of benefits over his lifetime as he would have gotten by retiring at 65. The current ***minimum retirement age*** is 62. Workers retiring at this age currently receive only 80 percent of the monthly benefit they would get if they retired at 65. This reduction remains in effect even after they reach 65. If a worker delays retirement until age 69, his monthly benefit is set at

[5] Workers also pay 2.9 percent into Medicare's Hospital Insurance (HI) Trust Fund. As with OASI and DI, workers pay half of this tax directly and half through their employers. Unlike OASI and DI taxes, there is no ceiling for HI taxes.

[6] Most experts generally use the 75-year period when calculating the long-term outlook for Social Security and Medicare. This time period is roughly equivalent to the life expectancy of an average worker.

[7] *1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, p. 23.

[8] This amount is indexed annually to the average wage and salaries of all employees.

109 percent of his PIA. Workers who delay retirement beyond the age of 69 are not compensated with higher benefits.

Under current law, the normal retirement age is scheduled to rise slowly beginning in 2002 until it reaches 67 by 2025. The minimum retirement age is not scheduled to change, however. Individuals will still be able to stop working and collect Social Security benefits when they reach 62, provided they are willing to accept the actuarial adjustment. In theory, Social Security expenditures do not increase over the long run if people retire at 62, since the government reduces the monthly benefit by the proper amount. The government does lose the payroll and income taxes that the retiree would have paid on his income while he continued working, however. The economy also loses the contribution of a productive worker, contributing to what many believe will be a future shortage of skilled labor.

Spousal and Survivor Benefits

Of course, working spouses face payroll taxes on their own earnings and are entitled to Social Security benefits based on those earnings. But even if a spouse does not work a sufficient number of years to qualify for full benefits, Social Security provides important spousal and survivor benefits. As soon as he/she reaches 65, a spouse is automatically entitled to a ***spousal benefit*** equal to 50 percent of the working spouse's PIA, provided they have been married 10 years.[9] Once the worker dies, the spouse is entitled to a ***survivor's benefit*** equal to 100 percent of the worker's PIA.

Finally, surviving dependent children under the age of 18 are entitled to monthly payments of 50 percent of the deceased worker's PIA and a widowed spouse caring for a child under age 16 is entitled to a payment of 75 percent of the PIA. These payments are subject to a family cap of between 150 percent and 187.5 percent of the PIA depending upon the worker's income.

Taxation of Benefits

Since 1983 some retirees have had to pay income tax on a portion of their Social Security benefits. The calculation of taxable benefits is complicated, but generally does not affect couples with total incomes below $32,000. Even the wealthiest beneficiaries pay income taxes on only 85 percent of their benefits. Instead of going into general revenue as other income taxes do, these taxes are credited to the Social Security trust funds.

[9] The spouse is eligible as soon as he/she has been married 10 years. He/she remains eligible even if there is a later divorce. The spouse may not collect, however, until the age of 65.

Plans To Reform Social Security

Several groups and individuals have already put forward plans to reform Social Security. Even the least reform-minded of these plans recommends changes that would have been unthinkable a decade ago. The boldest call for complete privatization.

In February 1997 the Advisory Council on Social Security (Council), appointed by President Clinton, issued its final report. The report had been delayed for almost a year because of disagreements among the Council members and a desire to avoid having Social Security become an issue in the 1996 election. The Councils' 13 members split into three groups, each making its own recommendations. The least reform-minded of these is called the Maintenance of Benefits (MB) option supported by six members, including all of the representatives from unionized labor. The plan proposing the most radical reform calls for the establishment of Personal Security Accounts (PSAs) controlled by each individual worker. It received the support of five Council members. The remaining two members supported an intermediate plan know as Individual Accounts (IAs).

In 1995 Senator Bob Kerrey (D-NE) and then-Senator Alan Simpson (R-WY) introduced legislation[10] that would allow individuals to divert two percentage points of their current FICA taxes into individual savings accounts. These accounts would be held by either the federal government or banking institutions, and workers would be able to direct how they were invested within a limited range of choices.

In addition, some private groups, most notably the Committee for Economic Development (CED), and the Cato Institute, have put forward alternative plans. The discussion below briefly summarizes the major elements of each of these proposals. Table 1 (page 4) highlights the main features of each plan.

The Advisory Council Recommendations

When the Advisory Council's long-overdue report was finally released in early 1997, it confirmed what newspapers had been reporting for many months: the Council was unable to form a consensus on a single plan for reform and instead had split into three groups, each supporting a different approach. At the time it met, Social Security's long-term deficit was estimated at 2.17 percent of taxable payroll, slightly lower than the most recent estimates.

[10] The legislation was introduced in the 104th Congress as S. 825. It has not been reintroduced in the 105th Congress.

Table 1

	Current Law	Maintenance of Benefits	Individual Accounts	Personal Security Account	Kerrey-Simpson (S. 825)	Committee for Economic Development	Cato Institute
Extend to New State and Local Employees	No	Yes	Yes	Yes	Yes	Yes	No
Total OASDI Tax	12.4	12.4 until 2045, then 14.0.	14.0	13.92 until 2068, then 12.4.	12.4	15.4	12.4. Drops to 10.0 in 10 years
Individual Accounts?	No	No	Yes	Yes	Yes	Yes	Yes
Amount Devoted to Individual Accounts	N/A	N/A	1.6 percentage points	5.0 percentage points	2.0 percentage points	3.0 percentage points	10.0 percentage points
Who controls plan?	N/A	N/A	Government	Individuals	Government or Banking institutions	Individuals	Individuals
Who makes investment decisions?	N/A	N/A	Individuals within limited choices	Individuals within broad choices	Individuals within limited choices	Individuals within broad choices	Individuals within broad choices
Retirement Age							
Normal Retirement Age	65 Increases to 67 by 2025	No change	Increased to 67 by 2015 and then indexed to longevity	Increased to 67 by 2015 and then indexed to longevity	Increased to 70 by 2029 and then indexed to longevity	Increased to 70 by 2030 and then indexed to longevity	Increased to 70 by 2029 and then indexed to longevity
Early Retirement Age	62	No change	No change	Increased to 65 by 2035	Increased to 65+	No change	No change
Determination of PIA							
Replacement Ratios	90-32-15	No change	90-22.4-10.5	No change	90-32-15-10	90-22.5-10.5	No change
Years Counted in Determining AIME	35	38	38	38	35	40	35
Other Benefits							
Minimum Spouse's Benefit	50 percent of PIA	No change	33 percent of PIA	No change	33 percent of PIA	33 percent of PIA	No change
Minimum Survivor's Benefit	50 percent of PIA	No change	75 percent of PIA	No change	No change	No change	No change

Consensus Changes

The Council members did agree on several reforms, however. All members agreed against recommending a legislative change in the CPI that governs annual cost-of-living-adjustments (COLA) to benefits. Most economists agree that the CPI overstates the actual rate of inflation. The Bureau of Labor Statistics (BLS) is studying changes to the CPI methodology that will lower its upward bias. The Council members supported these actions and assumed that they would lower COLA increases by 0.21 percentage points. This is a reasonable assumption given BLS estimates of their effect. Such a change would lower the actuarial deficit by 0.31 percent of taxable payroll, or 14 percent of the 2.17 percent goal the Council assumed was needed to balance Social Security.

Second, all but three of the members support making the program mandatory for all new employees of state and local governments. Interestingly, the three labor representatives were the only ones to oppose bringing these employees into the program. Forcing these workers into the Social Security system would lower the long-term actuarial imbalance by another 0.22 percent, or 10 percent of the total needed.

Third, the Council recommended revising the taxation of Social Security benefits. While opposed to the introduction of a test that would link the amount of benefits received to total income, the Council apparently had no problem favoring changes that would partially accomplish the same result, albeit indirectly. The taxation of Social Security benefits currently does not apply to single individuals who have adjusted gross income below $25,000 ($32,000 for couples). Each of the three plans recommends eliminating this provision by 2007, saving 0.16 percent of payroll, or 7 percent of 2.17. The additional revenues would be credited to the trust funds.

Most members also recommended increasing to 38 years the period over which the indexed average wage is computed. By including three additional lower paying years in the average yearly earnings, this change would lower the AIME and reduce monthly benefits by roughly 3 percent. The change would hurt lower income workers proportionately more than higher income workers but would lower the 75-year deficit by 0.28 percent of payroll (13 percent of the total needed).[11]

[11] As a footnote to the report points out, this change is not relevant to the PSA plan which switches to a different method of computing benefits. *Report to the 1994-1996 Advisory Council on Social Security, Volume I: Findings and Recommendations,* p. 20, n. 10.

Most members also supported further accelerating the increase in the normal retirement age and linking it to longevity. Under current law the retirement age is 67 for individuals born in 1960. A majority of members favor extending this age to all of the Baby Boom generation, those retiring in 2011 and after. After 2011, the retirement age would continue to rise with increases in life expectancy. This change would reduce the long-term deficit by 0.50 percent of payroll, four-fifths of which comes from indexing the age to future increases in longevity. This proposal would not change the minimum retirement age, however. Individuals would still be able to retire at age 62, although they would receive significantly lower benefits. Five of the supporters of the MB proposal opposed any change to the normal retirement age.

Finally, the Council recommended changes in the structure of family benefits. Under its plan, benefits to dependent spouses while both spouses are alive would be reduced gradually. In return, survivors' benefits, received after the death of one spouse, would be increased. This change is meant to reduce poverty among elderly surviving spouses. It would worsen the program's actuarial balance by 0.15 percent of taxable payroll, however.

Table 2
Consensus Recommendations of the Advisory Council

Recommendation	% of Taxable Payroll
Lower CPI by 0.21 percentage points	0.31
Include new state and local employees	0.22
Tax 85 percent of benefits for couples making under $32,000	0.16
Include highest 38 earning years	0.28
Accelerate increase in NRA	0.10
Index future NRA to longevity	0.40
Increase survivor benefits and lower spousal benefits	-0.15

Thus almost all members agreed on changes that collectively reduce the 75-year actuarial deficit by 0.82 percent of payroll. Eight of the 13 members also favored changes in the normal retirement age that would save another 0.50 percent of payroll. These

changes still fall short of the 2.17 percent needed to balance the program over the next 75 years. The members strongly disagreed on how to achieve the remaining savings.

Maintenance of Benefits

The MB approach is the least reform-mined of the major proposals being discussed, since it would make the fewest changes to Social Security's basic structure. It follows the formula used in the 1983 round of reforms, maintaining the program's basic structure, reducing benefits minimally, and slightly raising taxes. The MB proposal barely qualifies as a comprehensive plan. Three of the six members of the MB group oppose forcing new state and local government workers into Social Security. Yet this change accounts for 10 percent of the plan's savings. Another member opposes changes that account for another 13 percent of the savings. Most significantly, when it comes to the proposal that produces 37 percent of the plan's savings, the group was unwilling to recommend firmly changing the way in which the government invests surpluses in the Social Security trust fund. It was widely expected that the group would recommend moving a large portion of these surpluses into the stock market. In the end, however, the group declined to go this far, recommending only that the issue be studied. It is therefore difficult to give the MB proposal full credit for addressing the problem before it.

The MB group, which included all three of the representatives from unionized labor, is uncomfortable with the idea of investing funds in the stock market and accepting a higher degree of risk in order to earn a higher rate of return. They are even less comfortable with the idea of individual accounts, preferring a program in which everyone sinks or swims together. The problem is that, given demographic trends, it is very difficult to keep such a program afloat. The group does a poor job of making Social Security attractive to younger workers.

All of the MB members recommend changing the taxation of benefits so that all Social Security benefits are counted as taxable income to the extent that they exceed what the worker paid in. This is roughly equivalent to the current treatment of private defined-benefit plans. This change, combined with the elimination of the taxation exemption for those with annual incomes below $25,000 for singles and $32,000 for couples (discussed above) would lower the actuarial deficit by 0.31 percent.

Although a majority of the group seems comfortable with the idea of increasing the number of years included in the period for calculating the AIME from 35 to 38 years (discussed above), they offer an alternative of increasing both the employer's and the employee's share of payroll taxes by 0.3 percent, showing a strong bias for tax increases over spending cuts. One member opposed either option, preferring instead to increase the normal retirement age. The other members oppose changes to the retirement age, however, arguing that the increases already called for in current law are unfair.

The MB group also suggested changes in Social Security's relationship to Medicare. Under current law some of the revenues from taxing Social Security benefits are placed in Medicare's Hospital Insurance Trust Fund rather than Social Security's in order to keep the former solvent. The group favors reversing this transfer after Medicare's long-term financing problem has been solved. The change would improve Social Security's financing by 0.31 percent of taxable payroll but would reduce Medicare's by an equivalent amount. This recommended change only shifts the burden of addressing the problem to an area outside of the Council's scope of concern. The members did not feel compelled to say how Medicare should make up for the lost revenue.

Together these changes reduce the deficit by 1.37 percent of taxable payroll. The MB group did not make recommendations on how to achieve the remaining 0.80 percent. It points out that further savings could be achieved by raising payroll taxes or reducing benefits. But rather than relying on such changes immediately, it advocates studying the consequences of investing Social Security funds in the stock market. Although the group clearly does not advocate near-term enactment of the proposal, it still claims credit for the savings needed to balance the funding deficit.

Under the group's recommendation, Social Security surpluses might be invested gradually in a broad index of stocks. The estimates assume that investment in the private markets would begin in 2000 and reach 40 percent of the trust fund by 2015. The government would invest in a broad range of companies and adopt a neutral policy with regard to its stock voting rights. The group argues that the government could isolate these funds from political pressure to favor or discourage certain investments, as it has done for the much smaller Thrift Savings Plan.

Since these surpluses are currently invested in government bonds, the government would lose a major source of funding. The Congress and the Administration would have to issue new public debt, raise taxes, or reduce spending by an amount equivalent to that invested in the stock market. The MB proposal ignores this problem, however.

Finally in order to stabilize the program beyond the 75-year time frame, five of the six members recommend increasing both the employees' and the employers' share of payroll taxes by a total of 1.6 percentage points beginning in 2045. In order to avoid any fundamental reform in the structure of Social Security, members of the MB group are apparently willing to raise taxes on children not yet born.

Personal Security Accounts

Near the other end of the spectrum is the PSA proposal, supported by five Council members. This proposal would drastically alter the structure of Social Security, although it does not amount to full privatization.

Besides the consensus changes discussed above, the PSA plan would make several other changes within the program's existing structure. First, in addition to increasing the normal retirement age, it also would increase the early retirement age, now set at 62, to 65 years by 2035, and then keep it level. As a result, future retirees would no longer be able to begin collecting Social Security benefits at age 62, even though they are willing to accept a lower level of benefits. Unlike the normal retirement age, increases in the early retirement age would not be indexed to further increases in longevity. In order to ensure that benefits to disabled workers did not exceed the benefits to able retirees, the former would be reduced gradually as the retirement age increases. Reductions in disability benefits would be limited to 30 percent.

Second, the current retirement earnings test would be eliminated. Workers under the age of 70 have their benefits reduced if they continue to earn more than a minimum amount of wages. This reduces the incentive for older Americans to work by significantly raising their effective tax rate once they begin collecting benefits. The PSA plan would eliminate this penalty by 2002 for workers over the normal retirement age. Workers who retire early would still be subject to the earnings test.

The most significant change, however, is the shift from a statutory defined-benefit program to a personally directed defined-contribution program. Current retirees and workers age 55 and older in 1998 would still be covered under the old system. For these individuals, Social Security would remain basically as it is. Younger workers, however, would receive their retirement income in two tiers. Tier I would consist of a basic flat benefit paid to every retiree. For workers under the age of 25 in 1998, this benefit would be equal to $410 per month in 1996 prices. This benefit would be indexed to wages after 1998 until the worker retires and then price indexed thereafter. Since wages usually increase faster than inflation, the basic benefit would rise in real value over time.

Tier II would be financed by allowing each worker to divert five percentage points of his current share of the OASDI tax to a PSA. The PSA "would be individually owned and privately managed, subject to necessary regulatory restrictions to make sure they were invested in financial instruments widely available in financial markets and that they were held for retirement purposes."[12] Similar restrictions already govern Individual Retirement Accounts (IRAs), and the newspapers list literally hundreds of stock and mutual funds that would presumably qualify as investment choices. Workers could begin withdrawing funds from their account at the age of 62. Any funds remaining after death would be included in their estate.

The remaining portion of the OASDI taxes would be used to finance benefits to retirees under the current system and to pay for the Tier I benefit to all workers. Workers currently between the ages of 25 and 55 would begin diverting five percentage points of their payroll taxes into PSAs, but their Tier I benefit would be based on both the old and the new systems. Workers would have their accrued benefits calculated under the old system as of January 1, 1988. This amount would be wage-indexed until the worker becomes eligible to retire. The worker would also receive a portion of the $410 monthly flat benefit under the new system equal to the proportion of the working years between the ages of 22 and 61 that the worker spent in the new system.

Under the PSA plan, all benefits financed by the employer share of OASDI taxes (50 percent for current retirees and 100 percent of the Tier I benefits for younger workers) would be subject to income tax and these taxes would be credited to the trust fund. As a partial consequence, revenues from the taxation of Social Security benefits that are currently devoted to Medicare's Hospital Insurance Trust Fund would be diverted back into Social Security. The result would be an immediate worsening of Medicare's financial status. Like the MB group, the PSA group ignores the changes that would be needed to compensate for this loss of revenue. Because employees will have already paid income taxes on the five percentage points devoted to their PSAs, distributions from these accounts, including the inside buildup, would be tax free.

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[12] *Report of the 1994-1996 Advisory Council on Social Security, Volume I: Findings and Recommendations*, p. 30.

In order to fund the transition to the new system, the plan would increase the payroll tax by 1.52 percentage points for the next 72 years. Even with this tax increase, the government would still face a temporary shortfall, requiring it to issue approximately $1.9 trillion (in 1995 dollars) in additional debt by 2034. The increased taxes would cease once this additional debt was paid off.

Individual Accounts

The IA plan, supported by only two members of the Council, has often been referred to as a compromise between the MB and PSA plans. The IA plan creates separate accounts for each individual. But these accounts are much smaller than PSAs and control remains with the government, although workers would have a limited number of choices regarding how they are invested.

In addition to increasing the normal retirement age, forcing new state and local workers into the Social Security system, and extending the benefit computation period from 35 years to 38 years, the IA plan makes other changes to benefit and tax laws. The benefit for dependent spouses would fall from 50 percent to 33 percent of the worker's benefit. The minimum benefit to the surviving spouse, however, would increase to 75 percent of the couple's combined benefits. The intent of this change is to alleviate the high levels of poverty among surviving elderly spouses who are not eligible for Social Security benefits on their own. The IA plan also would reduce basic benefits to middle- and upper-income workers by lowering the replacement ratios used to convert average wages into a monthly benefit from the current levels of 32 percent and 15 percent to 22.4 percent and 10.5 percent, respectively (see discussion above on how benefits are calculated).

As in the MB plan, Social Security benefits in excess of those already taxed would be taxable and the current income thresholds would be phased out, but the current flow of some of these funds into Medicare's Hospital Insurance Trust Fund would not be reversed. Thus, unlike both the MB and the PSA plans, the IA plan does not strengthen Social Security at the expense of Medicare.

The main aspect of the IA plan, however, is an immediate increase of 1.6 percentage points in the employee's share of FICA taxes. This increase would not have to be matched by the employer. These additional taxes would be placed in an individual account and the worker would be given a limited number of investment choices, similar to those in most 401(k) plans. When the worker retires, the account would be converted to a single or joint minimum guarantee indexed annuity to ensure that it lasts throughout the worker's life.

The government could tax the proceeds from these accounts in either of two ways. If the additional payroll taxes were not included in taxable income for income tax purposes, then benefits would be taxed when paid out. Under current law, however, the employee's share of payroll taxes is included in taxable income. In this case, benefits from the account should not be counted as taxable income.

Over half of the IA program savings come from reducing the PIA replacement ratios. The plan's main feature, an increase in payroll taxes of 1.6 percentage points to fund IAs, increases the Social Security funds but, because the proceeds are paid out to the individual workers who pay the tax, it does nothing to address Social Security's long-term funding problem. If this feature were dropped from the plan, the other recommended changes would still balance the fund's finances over the next 75 years. The real purpose of the tax increase is not to shore up Social Security. It instead addresses its supporters' concern that workers are not saving enough for their own retirement. This also is true of the PSA plan, since its tax increase could be paid for by reducing the five percentage points that workers are allowed to divert into their own accounts.

Independent Plans To Balance Social Security

A number of other groups have put forward their own proposals for addressing Social Security's long-term funding problem. This report summarizes three of these proposals. The first was put forward by Senators Kerrey and Simpson in 1995 shortly after the Bipartisan Commission on Entitlement and Tax Reform failed to make progress on addressing the nation's long-term fiscal problem. This legislation was given the bill number S. 825 during the 104th Congress. Although Senator Simpson has since retired, Senator Kerrey continues to support the proposal and plans to introduce it again.

A number of research organizations have also put forward proposals for change. This report summarizes two of these plans. The CED plan represents the consensus of a group of senior business executives and academics who studied the issue in depth before recommending changes. The proposal by the Cato Institute advocates eventual privatization and therefore is at the opposite end of the spectrum from the MB proposal.

The Kerrey-Simpson Proposal (S. 825)

During the 104th Congress Senators Bob Kerrey and Alan Simpson cosponsored a bill to restructure and reform Social Security. Under the bill, every worker under the age of 55 would have 2.0 percentage points of his current payroll taxes placed in an individual account. The account would be managed by the federal government, and invested in the stock market so that it matched an index that was "a reasonably complete representation of the United States equity markets."[13] This presumably would be broader than the S&P 500. In addition to these individual accounts, the normal surplus of the trust fund would be diverted gradually to the private markets until 25 percent was invested in stocks by 2012. Workers could begin receiving distributions from their accounts at the age of 59½.

In order to pay for this diversion of funds from the trust fund, the bill makes several changes to the existing benefit formula. The normal retirement age would be raised gradually so that it reached 70 by 2028 and would keep rising after that by one-half month per year. The early retirement age also rises to 65 by 2016 and then stays constant until 2029 when it begins rising again. The age at which spouses could receive survivor's benefits also would rise gradually. A fourth replacement ratio of 10 percent is created so that workers earning higher salaries would have less of their taxable income replaced by benefits.

The bill would reduce the COLA in two ways. First, the annual increase for all beneficiaries would be set at the CPI minus 0.5 percentage points. Second, those receiving higher benefits would receive the same dollar increase as those in the 30th percentile, thus giving them a lower percentage increase. The spouse's insurance benefit would be reduced gradually from 50 percent to 33 percent by 2015. As with most other plans, coverage also is extended to new state and local employees.

S. 825 would strengthen the Social Security trust fund by having the portion of Social Security taxes that are now diverted to Medicare's Hospital Insurance plan rediverted back into the trust fund. This, of course, would worsen the financial status of Medicare. The bill does not address how to make up for this lost revenue. Nor does it explain how the federal government should finance its debt if a growing portion of the Social Security trust funds are invested in the stock market. These surpluses are now used to purchase federal debt. Without them the federal government would have to raise taxes, cut spending, issue more debt to the private sector, possibly at higher interest rates, or some combination of the three.

The Committee for Economic Development

CED is an independent research and policy organization of 250 business leaders and educators. The CED's Research and Policy Committee includes over two dozen senior executives of private companies. CED recently completed a study recommending reforms to the Social Security program.[14] The recommendations are interesting because they come from individuals representing the business community. Unlike most other plans, the CED proposal does not strengthen Social Security at the expense of other areas of the federal budget.

The CED reforms do not change the basic structure of Social Security. They do, however, raise payroll taxes to finance a new mandatory personal savings program. As with the Advisory Council's three plans, new state and local employees would be forced into the program. Beginning in 2002, the normal retirement age would be raised gradually until it reached 70 in 2030. The early retirement age would remain unchanged, however. Benefits to nonworking spouses also would be reduced gradually from 50 percent of the worker's benefit to 33 percent. Benefits to surviving spouses would remain the same. All benefits in excess of contributions made by the worker would be taxed as income, with the receipts flowing back into the trust fund. Finally, upper- and middle-income workers retiring after 2000 would have their initial benefits lowered in two ways. First, the replacement rates would be lowered gradually from 32 percent and 15 percent to 22.4 percent and 10.5 percent, respectively. Second, the number of years counted in determining the PIA would be raised from 35 to 40. Finally, CED recommends eliminating the current earnings test for retirees. Although this last change would increase benefits, it eliminates the disincentive to working longer. The changes recommended by CED would produce savings equal to 130 percent of the amount needed to bring the program into long-term balance. The program would therefore have a margin of error in case current forecasts once again turned out to be overly optimistic.

Having solved Social Security's financing problems, the CED proposal would go further to address what it perceives to be a shortage in national savings. The proposal calls for adding a second tier of defined-contribution benefits onto the current

[13] S. 825, 104th Congress, 1st Session, Section 10(a)(4).

[14] *Fixing Social Security,* CED, Washington, DC, 1997.

program. These benefits would be financed by raising immediately each worker's FICA taxes by 3.0 percentage points, with half paid directly and half paid through the employer. In a departure from current practice, the employee's share would not be subject to income tax. The additional taxes would be paid into individual accounts owned and controlled by the worker subject to a requirement that limits investments to broad-based funds. Because all payments are made with before-tax income, the benefits would be taxed when paid out. Regulations would prohibit employees from making withdrawals before they retire and would limit withdrawals so that the benefits lasted throughout the worker's expected lifetime.

The Cato Institute

One of the most notable plans for privatizing Social Security comes from the Cato Institute. Although the institute has not officially endorsed any one plan, it has issued papers by several authors advocating different privatization schemes. This report describes a proposal put forward by Peter Ferrara.[15]

Under the Ferrara plan, workers could choose to remain in the current program or use their payroll taxes to finance a private retirement account. Workers who choose the private plan would place 10 percent of their salary into private investment accounts, part of which would be used to pay for life and disability insurance. Half of this 10 percent payment will come directly from the worker and half will come from the employer. The remaining portion of the current tax of 12.4 percent would continue to be paid to the government to help finance the transition. After 10 years, however, this portion of the tax would be dropped, allowing workers' take-home pay to rise. Ferrara claims that a private system is capable of delivering at least three times the benefits of Social Security for the same amount of payments. As a result, he calculates that up until the age of 40 to 45, workers would still be better off in the private system, even if they received nothing from Social Security. However, under his plan the government would give those workers who exit Social Security bonds that they could place in their retirement accounts. The net present value of these "recognition" bonds would be equal to the proportion of Social Security benefits that the worker has already paid taxes for. A worker who is half way through his career would receive bonds equal to the value of half of the retirement benefits promised under current law. The bonds would be credited with interest and the worker could redeem them once he reached retirement. Unlike the benefits promised under current law, the bonds would be backed by the full faith and credit of the United States.

The government would continue to guarantee all workers a minimum benefit financed out of general revenues rather than payroll taxes. This program would thus have to compete with other programs for funding. Workers whose pension income was above the minimum would not receive anything from the government.

Existing workers who elect to remain in the Social Security program would receive the benefits currently promised to them, with some modifications. The rise in the normal retirement age would be extended so that it would rise by two months every year until it reaches 70. Early retirement would still be available at 62, although with a full actuarial reduction in benefits. In addition, workers' past salaries would be indexed to prices rather than wages when determining their initial benefit.

Unfortunately, the Ferrara proposal does not fully deal with all of the transitional questions. For instance, it recommends taking the current Social Security surpluses off budget so that they are not spent on other government programs. Like other proposals that include this recommendation, it does not explain how to make up for the lost source of financing for the government debt. In addition, he recommends further cuts in federal spending of $55 billion to $65 billion annually to help with the transition. He does not take a position on what programs should be cut.

The proposal also advocates issuing more government debt both in the form of recognition bonds issued to workers who opt out of the system and bonds issued to the general public in order to finance the transition. It is not clear how much debt the government would have to incur, however. Although this criticism also can be leveled at the other options discussed above, it is more serious here because the loss of revenues that results from allowing individuals to opt out is so great.

Conclusion

Once again Social Security faces a crossroads. The program's short-term finances are strong. Indeed, Social Security's current surpluses largely shield it from the budget pressure forcing cutbacks in Medicare and Medicaid. Nearly everyone agrees,

[15] Peter J. Ferrara, *A Plan for Privatizing Social Security,* The Cato Institute, Washington, DC, SSP No. 8, April 30, 1997. For another proposal see, David Altig and Jagadeesh Gokhale, *Social Security Privatization: One Proposal,* The Cato Institute, Washington, DC, SSP No. 9, May 29, 1997.

however, that the program's long-term financing is shaky. The looming retirement of the Baby Boomers will transform a large portion of the population from workers to retirees over a space of 40 years. Given the program's pay-as-you-go nature, this will require large tax increases unless benefit levels are cut.

Everyone also agrees that it is better to make changes sooner rather than later. The earlier changes are made, the less severe they have to be. Making changes now also gives those affected time to adjust their personal finances.

A number of individuals and groups have already put forward proposals for reforming Social Security and others will undoubtedly do so. The least reform-minded of these proposals make only marginal changes in the structure of the program, although the magnitude of the changes in tax rates and benefit cuts would have been labeled extreme less than a decade ago. The more ambitious proposals advocate complete privatization of personal retirement savings, usually accompanied by an income supplement program to support the poorest elderly. This report has summarized the basic features of six of the major proposals. A subsequent report will discuss the main issues involved in the broader debate over Social Security's future.

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