

# Strengthening Social Security and Creating Personal Wealth for All Americans

Report of the President's Commission

December 21, 2001

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## ***Introduction by the Co-Chairs***

From the first, Social Security was a work in progress. It remains so now. In 1939, just four years after enactment, the Administration and Congress added major provisions. FDR called for more. As he signed the 1939 Amendments he stated: “we must expect a great program of social legislation, as such as is represented in the Social Security Act, to be improved and strengthened in the light of additional experience and understanding.” He urged an “active study” of future possibilities.

One such possibility – personal retirement accounts that would endow workers with a measure of wealth – has emerged as the central issue in the ongoing national debate over social insurance.

There are a number of reasons for this. The first is the most obvious, if perhaps the least commented upon: Social Security retirement benefits are no longer the bargain they once were. There is nothing sinister about this. Early retirees benefited from the fixed formula of retirement benefits. For years the Social Security Administration would distribute photographs of Ida May Fuller of Ludlow, Vermont, who having paid \$24.75 in Social Security taxes lived to age 100 and collected \$22,889 in benefits.

In Miss Fuller’s time there were almost 42 covered workers for each Social Security beneficiary. We are now down to 3.4 workers per beneficiary. As a result, Social Security as a retirement measure has become a poor investment. It is, even so, an essential insurance program. Widows and dependent children are very reliant on dependent benefits. For widows, widowers, singles and children, the monthly check can be a steady, stabilizing factor in life. That said, however, Social Security’ actuaries estimate that, for a single male worker born in 2000 with average earnings, the real annual return on his currently-scheduled contributions to Social Security will be only 0.86 percent. This is not what sends savers to savings banks. For workers who earn the maximum amount taxed (currently \$80,400, indexed to wages) the real annual return is minus 0.72 percent.<sup>1</sup>

This should come as no surprise. Demography is a kind of destiny. The founders of Social Security always assumed it would be supplemented by individual forms of savings. (In his original Message to Congress, President Roosevelt envisioned pensioners owning annuities.) In the first instance, savings took the form of housing; government subsidies were created in the 1930s, followed by the enormous influence of Veterans Administration mortgages following World War II. By 2000, two-thirds – 67.4 percent – of Americans owned their homes.

The Crash of '29 left an indelible mark on the generation that lived through it -- and for that matter, the one that followed, such that direct investment in markets was slow in returning. But eventually it did.

Partly as a consequence of 1929, we have learned a great deal about how a modern economy works. During the Depression, the Federal government did not even calculate the unemployment rate; it was taken every ten years in the Census. Today, our economic statistics are extraordinary in range and accuracy, and since enactment of the Employment Act of 1946 economic policies have, on balance, been successful. The

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<sup>1</sup> OACT/SSA projections, May 27, 2001, Table 9.

great swings in economic activity have been radically mitigated. In November 2001, the Dating Committee of the National Bureau of Economic Research gave out its judgment that the period of economic expansion that began in March 1991 ended in March 2001. Such a ten-year period of uninterrupted growth is something never before recorded. There will continue to be ups and downs, and all manner of risks, but in the main the modern market economy appears to have settled down to impressive long-term growth.<sup>2</sup>

The post-World War II growth period was reflected, naturally enough, in the stock market. More important, a new form of investment, the mutual fund, was developed which enabled small savers to “pool” their investments over a range of stocks and bonds. As reported by the Investment Company Institute, “As of May, 2001, 93.3 million individuals, representing 52 percent of all U.S. households owned mutual funds.” Further, “Nearly half of mutual fund shareholders have household financial assets below \$100,000; 29 percent have less than \$50,000.”

The surge in mutual fund ownership began in the early 1980s. One of the more notable innovations was the development of a similar fund, the Thrift Savings Plan, as part of the retirement arrangements for Federal employees. The legislation was enacted quietly by Congress and signed by President Reagan in 1986. In terms of the markets, the timing could not have been better. The results have been stunning, as the Commission learned from testimony by the Director of the Federal Retirement Thrift Investment Board, Roger Mehle. Three funds were available, in whatever combination the employee chose. A “G” Fund is invested in short-term non-marketable U.S. Treasury securities specially issued to the TSP. An “F” Fund is invested in a commercial bond index; and a “C” Fund is invested in an equity index fund. The compound rates of return for the closing decade of the last century were as follows:

G Fund	6.7 percent
F Fund	7.9 percent
C Fund	17.4 percent

Actual trading is contracted out and administrative expenses are minimal: 50 cents for every \$1,000 of G Fund account balance, 70 cents for the F Fund, and 60 cents for the C Fund. (Additional funds are now being developed and offered.) As of September 2001, 86.6 percent of all Federal employees participated in the program. It is a singular success.

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<sup>2</sup> Even as the Commission proceeded, the Congress, at the behest of railroads and railroad unions, overwhelmingly adopted legislation which, as described by The New York Times “would allow the federally administered railroad pension system to take its assets out of government bonds for the first time and invest the money on Wall Street” (*The New York Times*, November 27, 2001). The House vote was 369-33; the Senate vote 90-9. Unlike the recommendations contained in this report, and the principles outlined in the Commission’s Executive Order, this legislation would effect collective investment of a Trust Fund as opposed to personal accounts. The Commission does not advocate collective investment, but does believe that Social Security recipients should have the benefit of such investment returns from personal accounts.

Martha Derthick's classic study Policy Making for Social Security begins with a quotation from Arthur Altmeyer, who was chief executive of the program from 1937 to 1953:

Social Security will always be a goal, never a finished thing because human aspirations are infinitely expandable... just as human nature is infinitely perfectible. (p. 17)

This would not quite have been the view of the Founders, who thought human nature to be anything but "infinitely perfectible." Hence checks and balances were needed to make up for the "defect of better motives." And indeed some things, notably demography, proved anything but perfectible. The Social Security tax (F.I.C.A. for Federal Insurance Contribution Act) began at two percent and has been raised more than twenty times, reaching the present 12.4 percent. This is a regressive tax that is paid on the first dollar of income by rich and poor alike. In fact, as of 1997, 79 percent of American households paid more in payroll taxes than in income taxes.<sup>3</sup>

One egregious failing of the present system is its effect on minorities with shorter life spans than the white majority. For black men age 20, only some 65 percent can be expected to survive to age 65. Thus, one of every three black youths will pay for retirement benefits they will never collect. No one intends this; and with time the gap may close. But it is not closed now. And because Social Security provides no property rights to its contributors – the Supreme Court has twice so ruled – a worker could easily work forty years then die and own not a penny of the contributions he has made for retirement benefits he will never collect. There are, to be sure, survivors and dependents benefits, but many workers die before eligibility for these is established. Disability insurance was added during the Eisenhower Administration so that workers are covered during their working years. But far too many never receive any retirement benefits and leave no estate.

Similarly, the present Social Security provision can prove unjust to women, especially divorced women who too often share nothing of the benefits acquired by a previous spouse. It is time we addressed this matter. There are a number of legitimate approaches that simply need to be worked out, with the plain objective of equal treatment.

As the early administrators of Social Security anticipated – and very much hoped for – the program steadily evolved. Health insurance (Medicare) was enacted in the 1960s. By the 1990s, the time had come for Personal Retirement Accounts. (As with much else in social insurance, other nations had preceded us.) In the mode of earlier innovations, the subject was first broached in academic circles, notably by economists such as Harvard's Martin Feldstein. In the fall of 1997, the Clinton Administration began to analyze proposals to create a system of individual retirement accounts, either as part of Social Security or outside of it. By early 1998, working groups were formed within Treasury and other departments to study issues related to such proposals.

A primary issue was how a feasible system of accounts could be administered and what would be the associated costs. In the spring of 1999 the Treasury had contracted a

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<sup>3</sup> Congressional Budget Office, "Effective Federal Tax Rates, 1979-1997," October 2001, p. xxi.

study by the State Street Bank entitled, “Administrative Challenges Confronting Social Security Reform.” The sum of it was that the task was feasible – the Thrift Savings Accounts were already in place – and the cost modest. Accenture (formerly known as Andersen Consulting) produced similar findings. In 1998 and 1999 a range of similar measures were introduced in Congress. None were enacted, but there was now a striking new item on the national agenda.

In the course of the Republican presidential primary campaign of 2000, then Governor George W. Bush gave a major address on Social Security, proclaiming it “the single most successful government program in American history...a defining American promise.” He went on to discuss Personal Retirement Accounts that would, in the words of a Democratic Senator, “take the system to its ‘logical completion.’” Then-Governor Bush envisioned a program that would “give people the security of ownership,” the opportunity “to build wealth, which they will use for their own retirement and pass on to their children.” He cited a range of legislators, Republican and Democrat, who shared this general view, including Senator Bob Kerrey, who had recently stated: “It’s very important, especially for those of us who have already accumulated wealth, to write laws to enable other people to accumulate it.” Governor Bush then added:

Ownership in our society should not be an exclusive club. Independence should not be a gated community. Everyone should be a part owner in the American dream.

In his address, then-Governor Bush insisted that “personal accounts are not a substitute for Social Security,” but a supplement, a logical completion. He proposed several measures necessary to ensure the long-term fiscal viability of Social Security itself. Among them was the following:

Reform should include personal retirement accounts for young people – an element of all the major bipartisan plans. The idea works very simply. A young worker can take some portion of his or her payroll tax and put it in a fund that invests in stocks and bonds. We will establish basic standards of safety and soundness, so that investments are only in steady, reliable funds. There will be no fly-by-night speculators or day trading. And money in this account could only be used for retirement, or passed along as an inheritance.

Personal retirement accounts within Social Security could be designed and financed in a number of ways, some of which are analyzed by the Commission in detail in the pages that follow. To illustrate the power of personal accounts, however, let us offer the following example. This approach would establish an opportunity for all people with earnings to set up a personal retirement account, on a voluntary basis. These accounts could be financed by the individual worker voluntarily adding one percent of his pay on top of the present 6.2 percent employee share of the Social Security payroll tax. The Federal government could match the employee’s contribution with a matching one percent of salary, drawn from general revenues. The result would be retirement savings accounts for all participating American workers and their families, which might or might not interact directly with the Social Security system, depending on design choices that are discussed further in Chapter 4. The cost to the Federal government would be

approximately \$40 billion per year, depending on rates of participation. The magic of compound interest now commences to work its wonders.

To illustrate what a participant might anticipate from setting aside one percent of his or her pay, matched with the government's one percent, we can forecast the situation of a "scaled medium earner" entering the workforce at age 21 and retiring at age 65 in the year 2052.<sup>4</sup> Assume a portfolio choice – there should be choices – roughly that of the current Thrift Savings Plan: 50 percent corporate equity, 30 percent corporate bonds, and 20 percent U.S. Treasury bonds. Real yields are assumed to be 6.5 percent for equities, 3.5 percent for corporate bonds, and 3 percent for Treasury bonds. Also assume that this worker pays 0.3 percent of his account assets for annual administrative costs. At retirement, she or he will have an expected portfolio worth \$523,000 (\$101,000 in constant 2001 dollars). A two-earner family could easily have an expected net "cash" worth of \$1 million.

As the Commission's interim report has shown, Social Security is in need of an overhaul. The system is not sustainable as currently structured. The final report demonstrates that there are several different approaches that national policymakers could take to address the problem, and we hope the pages that follow will provide sufficient analysis and suggestion to prompt a reasoned debate concerning how best to strengthen Social Security.

In the accompanying report, the Commission recommends that there be a period of discussion, lasting for at least one year, before legislative action is taken to strengthen and restore sustainability to Social Security. Regardless of how policymakers come to terms with the underlying sustainability issues, however, one thing is clear to us: the time to include personal accounts in such action has, indeed, arrived. The details of such accounts are negotiable, but their need is clear. The time for our elected officials to begin that discussion, informed by the findings in this report, is now.

Carpe diem!

Daniel Patrick Moynihan  
Co-Chairmen, President's Commission to Strengthen Social Security  
Richard D. Parsons  
December 21, 2001

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<sup>4</sup> Today, a scaled medium earner earns \$35,277 annually.

## ***Executive Summary***

### **Findings:**

Social Security will be strengthened if modernized to include a system of voluntary personal accounts. Personal accounts improve retirement security by facilitating wealth creation and providing participants with assets that they own and that can be inherited, rather than providing only claims to benefits that remain subject to political negotiation. By allowing investment choice, individuals would be free to pursue higher expected rates of return on their Social Security contributions. Furthermore, strengthening Social Security through personal accounts can add valuable protections for widows, divorced persons, low-income households and other Americans at risk of poverty in old age.

Partial advance funding of Social Security should be a goal of any effort to strengthen the system. Advance funding within Social Security can best be accomplished through personal accounts rather than direct government investment. Personal accounts offer numerous economic benefits, including a likely increase in national saving, as well as an improvement in incentives for labor force participation.

Personal accounts can be administered in an efficient and cost effective manner. This report outlines specific measures that would effectively balance the desire for low administrative costs along with consumer choice and efficient financial markets. Accounts should be structured so as to allow inheritability and to strengthen the protection of spouses.

Personal accounts can also contribute towards the fiscal sustainability of the Social Security system. While there are multiple paths to fiscal sustainability that are consistent with the President's principles for Social Security reform, we have chosen to include three reform models in the report that improve the fiscal sustainability of the current system, are costed honestly, and are preferable to the current Social Security system.

Under the current system, benefits to future retirees are scheduled to grow significantly above the level received by today's retirees, even after adjusting for inflation. The cost of paying these benefits will substantially exceed the amount of payroll taxes collected. To bring the Social Security system to a path of fiscal sustainability—an essential task for any reform plan—there are differing approaches. The Commission believes that no matter which approach is taken, personal accounts can increase expected benefits to future participants in the Social Security system.

Each of the three reform plans abides by the President's Principles for reform.

### ***The President's Principles***

The President directed the Commission to propose Social Security reform plans that will strengthen Social Security and increase its fiscally sustainability, while meeting several principles:

- Modernization must not change Social Security benefits for retirees or near-retirees.
- The entire Social Security surplus must be dedicated to Social Security only.
- Social Security payroll taxes must not be increased.
- Government must not invest Social Security funds in the stock market.
- Modernization must preserve Social Security's disability and survivors components.
- Modernization must include individually controlled, voluntary personal retirement accounts, which will augment the Social Security safety net.

### ***Unifying Elements of the Three Reform Plans***

- The Commission has developed three alternative models for Social Security reform that feature personal accounts as a central component. Under all three reform plans, future retirees can expect to receive benefits that are at least as high as those received by today's retirees, even after adjusting for inflation.
- All three models include a voluntary personal retirement account that would permit participants to build substantial wealth and receive higher expected benefits than those paid to today's retirees. Thus, all of the plans would enhance workers' control over their retirement benefits with accounts that they own and can use to produce retirement income, or pass on to others in the form of an inheritance.
- Because the Commissioner believes that the benefits currently paid to low-wage workers are too low, it has included a provision in two of the three plans that would enhance the existing Social Security system's progressivity by significantly increasing benefits for low-income workers above what the system currently pays. This provision will raise even more of our low-income elderly – most of whom are women – out of poverty. Two of the three models also boost survivor benefits for below-average income widows and widowers.
- The Commission set a goal of moving the Social Security system toward a fiscally sustainable course that reduces pressure on the remainder of the federal budget and can respond to economic and demographic changes in the future. The three reform models outlined here are therefore transparently

scored in terms of plan provisions, effects on workers' expected costs and benefits, and effects on Trust Fund operations as well as the unified federal budget. We also identify clearly how large the personal account assets may be expected to grow as the system evolves.

- All three reform models improve the fiscal sustainability of the program, though some move farther than others. Model 1 would require additional revenues in perpetuity in order to pay scheduled Social Security benefits under the plan. Model 3 prescribes an amount of additional revenues needed to pay scheduled benefits under the plan, an amount smaller than that required under Model 1. Model 2 does not require permanent additional funding.
- All three models also require transitional investments to move to a system that includes Personal Accounts. These transitional investments advance fund future benefits, thus substantially reducing the cost on future generations.
- All three models reduce the long-term need for general revenues as compared to the current, unsustainable, system. In two of the three plans (Models 2 and 3), the system's cash flow needs are met so that the benefits promised by each plan can be paid as retirees need them.
- All three of the models are expected to increase national saving, though some would do so more than others.
- The Commission concludes that building substantial wealth in personal accounts can be and should be a viable component of strengthening Social Security. We commend our three models to the President, the Members of Congress and to the American public in order to enrich national understanding of the opportunities for moving forward.

### ***Three Reform Models***

The three models for Social Security reform devised by the Commission demonstrate how alternative formulations for personal accounts can contribute to a strengthened Social Security system.

Reform Model 1 establishes a voluntary personal account option but does not specify other changes in Social Security's benefit and revenue structure to achieve full long-term sustainability.

- Workers can voluntarily invest 2 percent of their taxable wages in a personal account.

- In exchange, traditional Social Security benefits are offset by the worker's personal account contributions compounded at an interest rate of 3.5 percent above inflation.<sup>5</sup>
- No other changes are made to traditional Social Security.
- Expected benefits to retirees rise while the annual cash deficit of Social Security falls by the end of the valuation period.
- Workers, retirees, and taxpayers continue to face uncertainty because a large financing gap remains requiring future benefit changes or substantial new revenues.
- Additional revenues are needed to keep the trust fund solvent starting in the 2030s.

Reform Model 2 enables future retirees to receive Social Security benefits that are at least as great as today's retirees, even after adjusting for inflation, and increases Social Security benefits paid to low-income workers. Model 2 establishes a voluntary personal account without raising taxes or requiring additional worker contributions. It achieves solvency and balances Social Security revenues and costs.

- Workers can voluntarily redirect 4 percent of their payroll taxes up to \$1000 annually to a personal account (the maximum contribution is indexed annually to wage growth). No additional contribution from the worker would be required.
- In exchange for the account, traditional Social Security benefits are offset by the worker's personal account contributions compounded at an interest rate of 2 percent above inflation.<sup>6</sup>
- Workers opting for personal accounts can reasonably expect combined benefits greater than those paid to current retirees; greater than those paid to workers without accounts; and greater than the future benefits payable under the current system should it not be reformed.
- The plan makes Social Security more progressive by establishing a minimum benefit payable to 30-year minimum wage workers of 120 percent of the poverty line. Additional protections against poverty are provided for survivors as well.
- Benefits under the traditional component of Social Security would be price indexed, beginning in 2009.
- Expected benefits payable to a medium earner choosing a personal account and retiring in 2052 would be 59 percent above benefits currently paid to today's retirees. At the end of the 75-year valuation period, the personal account system would hold \$12.3 trillion (in today's dollars; \$1.3 trillion in present value), much of which would be new saving. This accomplishment would need neither increased taxes nor increased worker contributions over the long term.
- Temporary transfers from general revenue would be needed to keep the Trust Fund solvent between 2025 and 2054.

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<sup>5</sup> In practice, this would be computed as the Treasury Bond yield plus 50 basis points.

<sup>6</sup> In practice, this would be computed as the Treasury Bond yield minus 100 basis points.

- This model achieves a positive system cash flow at the end of the 75-year valuation period under all participation rates.

Reform Model 3 establishes a voluntary personal account option that generally enables workers to reach or exceed current-law scheduled benefits and wage replacement ratios. It achieves solvency by adding revenues and by slowing benefit growth less than price indexing.

- Personal accounts are created by a match of part of the payroll tax – 2.5 percent up to \$1000 annually (indexed annually for wage growth) – for any worker who contributes an additional 1 percent of wages subject to Social Security payroll taxes.
- The add-on contribution is partially subsidized for workers in a progressive manner by a refundable tax credit.
- In exchange, traditional Social Security benefits are offset by the worker’s personal account contributions compounded at an interest rate of 2.5 percent above inflation.<sup>7</sup>
- The plan makes the traditional Social Security system more progressive by establishing a minimum benefit payable to 30-year minimum wage workers of 100 percent of the poverty line (111 percent for a 40-year worker). This minimum benefit would be indexed to wage growth. Additional protections against poverty are provided for survivors as well.
- Benefits under the traditional component of Social Security would be modified by:
  - ◆ adjusting the growth rate in benefits for actual future changes in life expectancy,
  - ◆ increasing work incentives by decreasing the benefits for early retirement and increasing the benefits for late retirement, and
  - ◆ flattening out the benefit formula (reducing the third bend point factor from 15 to 10 percent).
- Benefits payable to workers who opt for personal accounts would be expected to exceed scheduled benefit levels and current replacement rates.
- Benefits payable to workers who do not opt for personal accounts would be over 50 percent higher than those currently paid to today’s retirees.
- New sources of dedicated revenue are added in the equivalent amount of 0.6 percent of payroll over the 75-year period, and continuing thereafter.
- Additional temporary transfers from general revenues would be needed to keep the Trust Fund solvent between 2034 and 2063.

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<sup>7</sup> In practice, this would be computed as the Treasury Bond yield minus 50 basis points.

<b>Specifications of Commission Reform Models</b>			
	<b><u>Model 1</u></b>	<b><u>Model 2</u></b>	<b><u>Model 3</u></b>
<b>PERSONAL ACCOUNTS</b>			
Personal Account Size	2%	4% up to \$1000 annually (indexed to wages each year)	1% new contribution plus 2.5% up to \$1000 annually (indexed to wages each year)
Voluntary	Yes	Yes	Yes
Additional Contributions Required?	This is a generic 2% plan that can be done with or without new contributions	None	1% of wages required to participate (subsidized through income tax system)
Real return that makes person better off with accts than without (SS defined benefit offset rate).	3.5%	2.0%	2.5%
Accounts owned by participants?	Yes	Yes	Yes
Accounts can be bequeathed to heirs?	Yes	Yes	Yes
Participants can choose from a mix of low-cost, diversified portfolios?	Yes	Yes	Yes
Contributions and account earnings splitting in case of divorce?	Yes	Yes	Yes
<b>TRADITIONAL SOCIAL SECURITY BENEFITS</b>			
New minimum benefit	None	By 2018, a 30-year minimum wage worker is guaranteed benefit equal to 120% of poverty level, inflation indexed.	By 2018, a 30-year minimum wage worker is guaranteed benefit equal to 100% of poverty level (111% for a 40-year worker), then rising with national wage growth.
Widow/Widower Benefits	No changes	Increased to 75% of couple benefits (vs. 50% to 67% today) for	Increased to 75% of couple benefits (vs. 50% to 67% today) for

		lower wage couples	lower wage couples
Changes to growth rate of traditional benefit for future retirees	None specified	Indexed to inflation instead of wages starting for those turning 62 in 2009.	Indexed to gains in average life expectancy (results in average annual growth of 0.5% over inflation)
Additional changes to traditional benefit formula	None specified	None specified	<ol style="list-style-type: none"> <li>1. Reduce benefit for early retirement and increase benefit for late retirement</li> <li>2. Gradually decrease bend point factor for highest income bend point from 15% to 10% starting in 2009</li> </ol>

<b>Reform Model 1: Increase in Total Benefits for Account Holders* Relative to Current Retirees</b>			
	<u>Annual Benefit Levels (in 2001 dollars)</u>		
Retirement Year	Low-wage worker	Medium-wage worker	High-Wage worker
2001	\$7,644	\$12,624	\$16,392
2032	\$10,140	\$16,944	\$22,620
Percent increase over current retiree	32%	34%	38%
2052	\$9,624**	\$16,476**	\$22,428**
Percent increase over current retiree	26%	31%	37%
** Assumes the current system will pay benefits affordable under current law: \$8,568, \$14,148, and \$18,696, for low, average, and high earners respectively. Currently scheduled benefits are \$11,832, \$19,536 and \$25,812 respectively, but the system is projected to be 27.6% underfunded in 2052. Assuming that currently scheduled benefits are met, the total expected benefit with personal accounts would be: \$12,888, \$21,864 and \$29,544 respectively.			

<b>Reform Model 2: Increase in Total Benefits for Account Holders* Relative to Current Retirees</b>			
	<u>Annual Benefit Levels (in 2001 dollars)</u>		
Retirement Year	Low-wage worker	Medium-wage worker	High-Wage worker
2001	\$7,644	\$12,624	\$16,392
2032	\$11,160	\$15,444	\$19,680
Percent increase over current retiree	46%	18%	17%
2052	\$13,608**	\$20,016**	\$24,684**
Percent increase over current retiree	78%	59%	51%
** Assumes the current system will pay benefits affordable under current law: \$8,568, \$14,148, and \$18,696, for low, average, and high earners respectively. Currently scheduled benefits are \$11,832, \$19,536 and \$25,812 respectively, but the system is projected to be 27.6% underfunded in 2052.			

<b>Reform Model 3: Increase in Total Benefits for Account Holders* Relative to Current Retirees</b>			
	Annual Benefit Levels (in 2001 dollars)		
Retirement Year	Low-wage worker	Medium-wage worker	High-Wage worker
2001	\$7,644	\$12,624	\$16,392
2032	\$10,932	\$17,412	\$22,620
Percent increase over current retiree	43%	38%	38%
2052	\$14,112**	\$23,796**	\$31,668**
Percent increase over current retiree	85%	88%	93%
** Assumes the current system will pay benefits affordable under current law: \$8,568, \$14,148, and \$18,696, for low, average, and high earners respectively. Currently scheduled benefits are \$11,832, \$19,536 and \$25,812 respectively, but the system is projected to be 27.6% underfunded in 2052.			

<b>Summary Results: Fiscal Sustainability Assuming 2/3 Participation in Personal Accounts (PA)</b>	<b>Model 1 <sup>1/</sup></b>	<b>Model 2</b>	<b>Model 3</b>	<b>Current Law</b>
<b>1. Expected PA assets at end of 2075 (\$PV trillions)</b>	\$1.1	\$1.3	\$1.6	NA
<b>2. Gain in Social Security "system" assets at end of 2075</b> (Increase in Trust Fund + Expected PA Assets; \$PV trillions)	\$0.5	\$4.8	\$5.0	NA
<b>3. Reduction in cash flow requirements from general revenue relative to present law <sup>2/ 3/</sup></b>				
Reduction in 75-year total (Sum of Ann Amts in \$2001 trillions)	\$1.7	\$14.8	\$11.3	\$0.0
<i>Percent reduction versus current law (in \$2001)</i>	7.7%	68.1%	52.2%	0.0%
Reduction in 75-year total (\$PV trillions)	-\$0.2	\$2.3	\$1.7	\$0.0
<i>Percent reduction versus current law (in PV)</i>	-3.8%	45.0%	33.9%	0.0%
<b>4. Social Security Cashflow</b>				
<b>With dedicated general revenue</b>				
Positive by end of valuation window?	No	Yes	Yes <sup>4/</sup>	No
Income Rate (incl. GR Transfer)-Cost Rate in 2075 (% of payroll)	-4.56	1.41	0.12 <sup>4/</sup>	-6.05
<b>Without dedicated general revenue <sup>3/</sup></b>				
Positive by end of valuation window?	No	Yes	No	No
Income Rate (excl. GR Transfer)-Cost Rate in 2075 (% of payroll)	-4.56	1.41	-0.75	-6.05
<b>5. Improvement in Actuarial Balance over 75-year period</b>				
Improvement with general revenue transfer (% of payroll)	-0.32	1.99	1.88	0
<i>Percent improvement with general revenue transfer</i>	-17%	107%	101%	
Improvement without general revenue transfer (% of payroll) <sup>3/</sup>	-0.32	1.15	0.87 <sup>5/</sup>	0
<i>Percent improvement without general revenue transfer</i>	-17%	62%	47%	
<b>6. Transition investment</b>				
<b>Assuming current law surplus not used for financing <sup>6/</sup></b>				
\$ PV trillions	\$1.1	\$0.9	\$0.4	
<i>As % of GDP over years included in calculation</i>	0.36%	0.49%	0.25%	
<b>Includes current law surplus available for financing <sup>7/</sup></b>				
\$ PV trillions	\$0.7	\$0.4	\$0.1	NA
<i>As % of GDP over years included in calculation</i>	0.29%	0.33%	0.10%	NA
<b>Notes:</b>				
1/ Model 1 does not include additional transfers for balance.				
2/ Cash flow requirements are defined as general revenue required in any year to maintain solvency in the absence of dedicated revenues.				
3/ Taxes on benefits and on PRA distributions are treated as Social Security revenues, not general revenue.				
4/ Includes new dedicated sources of revenue; see text.				
5/ Improvement in actuarial balance would be +1.50 if new dedicated sources of revenue are included; see text.				
6/ Unified budget concept: Diff between income and cost of proposed model versus present law				
7/ Reflects extent to which negative balance in any year is more negative than under current law.				

## **Chapter 1: Strengthening Social Security Through Personal Accounts**

### *Summary of Findings:*

Social Security will be strengthened if modernized to include a system of voluntary personal accounts.

*Retirement security will be increased through personal accounts because they would facilitate wealth creation for individual participants.*

*Financial security is enhanced by asset ownership. Correspondingly, retirement security for Social Security participants will be enhanced by ownership of assets accumulated through the Social Security system, relative to a claim to benefits that must remain subject to political negotiation.*

*Social Security should be extended to include inheritable assets.*

*Strengthening Social Security to include personal accounts can add valuable protections for widows, divorced persons, low-income households and other Americans at risk of poverty in old age.*

*Personal accounts would permit individuals to seek a higher rate of return on their Social Security contributions, offering higher total expected benefits to individuals with accounts than those lacking them.*

*Partial advance funding of Social Security should be a goal of any effort to strengthen the system.*

*Advance funding within Social Security can best be accomplished through personal accounts rather than direct government investment.*

*The Commission finds that the establishment of personal accounts is likely to lead to an increase in national saving.*

*The Commission believes that the establishment of personal accounts will improve incentives for labor force participation.*

## *Introduction*

In President Bush's Executive Order establishing the Commission to Strengthen Social Security, he instructed the Commission to submit "bipartisan recommendations to modernize and restore fiscal soundness to the Social Security system."

The Commission has reviewed dozens of possible future courses for Social Security, including several developed by outside experts, and projections developed by the Office of the Chief Actuary of the Social Security Administration.

These examinations have led us to the following conclusions concerning the establishment of personal accounts within the Social Security system.

*Finding: It is the finding of the President's bipartisan commission that Social Security will be strengthened if modernized to include a system of voluntary personal accounts.*

Specifically, the Commission finds that the Social Security system would be strengthened through personal accounts *regardless* of the level of benefits promised from, and the level of revenues committed to, the Social Security system. These are decisions that are yet to be made by the Congress and the President, involving trade-offs elucidated later in this report.

However, whether additional revenues are committed to the Social Security system or benefit growth is brought to a level that can be sustained within currently projected revenues, the Commission finds that the creation of personal accounts will enhance retirement security, for reasons outlined on the following pages.

In other words, changes in benefit growth are not proposed to finance personal accounts. Changes in benefit growth are required to bring Social Security towards solvency without tax increases; personal accounts can allow workers to recover most, if not all, of the changes in scheduled benefits.

*Finding: Retirement security will be increased through personal accounts because they would facilitate wealth creation for individual participants.*

Approximately half of United States households save nothing in an average year, and millions hold no appreciable financial assets. Establishing personal accounts within Social Security would advance a highly progressive principle: accumulating assets for the half of American households who have not compiled this measure of wealth after contributing 12.4 percent of their wages to support the Social Security system.

This 12.4 percent of wages paid into Social Security currently buys for these Americans an inflation-indexed annuity upon retirement, as well as insurance against disability and protections for dependents and survivors. The Commission believes these protections should be continued. Projections show that if a portion of this 12.4 percent is contributed to personal accounts, these protections can continue, while at the same time establishing the progressive result of creating a measure of wealth through financial asset ownership for millions of Americans who do not now enjoy it.

In testimony before the Commission, Professor Michael Sherraden of Washington University stated that:

For the vast majority of households, the pathway out of poverty is not through income and consumption but through saving and accumulation.... When people begin to accumulate assets, their thinking and behavior changes as well. Accumulating assets leads to important psychological and social effects that are not achieved in the same degree by receiving and spending an equivalent amount of regular income.

Accumulating research shows that asset accumulation has positive effects on individual well-being that extend far beyond the income those assets provide. In other words, personal accounts can be more than simply a way to provide Social Security benefits. By saving and accumulating assets in an account, individuals and their families benefit in other ways as well.

## Examples:

- Several studies show that asset-holding has a substantial positive effect on long-term health and marital stability, even when controlling for income, race and education.<sup>8</sup>
- Among participants in trial programs of individual development accounts, 84 percent report feeling more economically secure, 59 percent report being more likely to make educational plans, and 57 percent report being more likely to plan for retirement because they are involved in an asset-building program.<sup>9</sup>
- Individuals with investment assets, and their children, perform better on educational tests and reach higher educational attainment, even after accounting for income.<sup>10</sup>
- Single mothers and their children are less likely to live in poverty if the mother came from a family with asset holdings, even after controlling for education and socio-economic status.<sup>11</sup>
- Saving patterns are passed on from parents to children; parents who save are more likely to have children who save, even after other factors are counted.<sup>12</sup>
- Among individuals with experimental Individual Development Accounts, 93 percent say they feel more confident about the future and 85 percent more in control of their lives because they are saving. Approximately half of account holders report that having accounts makes them more likely to have good relationships with family members, and 60 percent say that they are more likely to make educational plans for their children because they are saving.<sup>13</sup>

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<sup>8</sup> Galligan, R. J. & Bahr, S.J. (1978). Economic well-being and marital stability: Implications for income maintenance programs. *Journal of Marriage and the Family*, 283-290; Hampton, R. L. (1982). Family life cycle, economic well-being and marital disruption in black families. *California Sociologist*, 5, 16-32 South, S. J. & Spitze, G. (1986). Determinants of divorce over the marital life course. *American Sociological Review*, 51, (4), 583-590.

<sup>9</sup> Moore, A., Beverly, S., Schreiner, M., Sherraden, M., Lombe, M., Cho, E., Johnson, L. & Vonderlack, R. (2001). *Saving, IDA programs, and effects of IDAs: A survey of participants. Downpayments on the American Dream Policy Demonstration: A national demonstration of Individual Development Accounts.* Washington University in St. Louis, George Warren Brown School of Social Work, Center for Social Development.

<sup>10</sup> Mayer, S. (1997). *What money can't buy: Family income and children's life chances.* Cambridge: Harvard University Press; Hill, M.S. & Duncan, G. J., (1987). Parental family income and the socioeconomic attainment of children. *Social Science Research*, 6, 39-73.

<sup>11</sup> Cheng, L. (1995). Asset holding and intergenerational poverty vulnerability in female-headed families. Paper presented at the Seventh International Conference of The Society for the Advancement of Socio-Economics, April 7-9, Washington, DC.

<sup>12</sup> Pritchard, ME, Meyers, BK, & Cassidy, D (1989). Factors associated with adolescent saving and spending patterns. *Adolescence* 24 (95), 711-723.

<sup>13</sup> Moore et al., 2001.

Moreover, recent research has concluded that individuals with personal defined contribution accounts would voluntarily choose to save more than individuals with a comparable defined benefit plan. This is important, given the importance of reforming Social Security in a manner that increases national saving.<sup>14</sup> The authors find that “interest in leaving a bequest ... is positively related to the proportion of pension wealth received as lump sums rather than annuities. Thus, it appears that lump-sum payments affect intended as well as unintended bequests.” Moreover, “workers react very differently to their defined contribution accumulations than they do to the present value of annuity pensions. They do not reduce their other saving in anticipation of payments from defined contribution plans as they do in response to promised Social Security and defined benefit pension payments. Finally, the most significant increase in lump-sum pension accumulations occurs in the middle and lower quintiles of the wealth distribution, so that the increase in bequests should help to reduce wealth inequality.”<sup>15</sup>

“Asset poverty” is of particular concern to minorities. Sherraden reported to the Commission that that while the median income of whites versus African Americans is 1.6-to-1, the median net worth ratio is 11-to-1. Similar disparities exist between whites and Hispanics.

The benefits of personal asset ownership could not be achieved either through the Social Security system as currently structured or through government investment of the trust fund in the stock market.

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<sup>14</sup> Alicia H. Munnell, Mauricio Soto, Annika Sundén, and Catherine Taylor, “The Impact Of The Shift To Defined Contribution Plans On Bequests And Living Standards In Retirement,” Prepared for “The Role and Impact of Gifts and Estates,” Conference Sponsored by the Center for Retirement Research at Boston College, Woodstock, VT, October 21-23, 2001

<sup>15</sup> Munnell, et al, p.3

*Finding: Financial security is enhanced by asset ownership. Correspondingly, retirement security for Social Security participants will be enhanced by ownership of assets accumulated through the Social Security system, relative to a claim to benefits that must remain subject to political negotiation.*

Throughout the history of Social Security, benefit formulas have been statutorily altered numerous times. Benefits have been expanded when deemed affordable to do so, and reduced in response to financial pressures. The large projected Social Security funding shortfall virtually ensures that benefits from the traditional Social Security system will remain at risk of being reduced, compromising the retirement security of participants.

The Social Security Administration points out that:

There has been a temptation throughout the program's history for some people to suppose that their FICA payroll taxes entitle them to a benefit in a legal, contractual sense. That is to say, if a person makes FICA contributions over a number of years, Congress cannot, according to this reasoning, change the rules in such a way that deprives a contributor of a promised future benefit.<sup>16</sup>

However, the SSA notes, "Congress clearly had no such limitation in mind when crafting the law."

"Like all federal entitlement programs," the Social Security Administration acknowledges, "Congress can change the rules regarding eligibility--and it has done so many times over the years. The rules can be made more generous, or they can be made more restrictive. Benefits which are granted at one time can be withdrawn, as for example with student benefits, which were substantially scaled-back in the 1983 Amendments."

By contrast, assets held in personal accounts would be more secure. The owner could choose the level of risk to which such assets are to be subjected through investment policies, but there is little substantial risk that these assets will be taken away, other than through the normal process of income taxation. Personal accounts, which would give workers a legal right to their assets and the benefits derived from them, thus provide a substantially stronger guarantee than does the current unsustainable program.

International experience bears out this judgment. At the Commission's San Diego public hearing, Anita Schwartz of the World Bank noted that in many countries where participation in personal accounts was voluntary, many workers opted for a personal account even when "on paper" it appeared that they would have received higher benefits through the traditional system. For instance, Schwartz noted that experts in Uruguay had projected that less than 15 percent of the 600,000 participants in the traditional social security system would opt for personal accounts, but that when the choice came, more than two-thirds actually did so. One reason, Schwartz said, is that many people feel more secure with an asset than with an entitlement: an account that is

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<sup>16</sup> Social Security Administration website; <http://www.ssa.gov/history/nelson.html>

their own property is perceived to be safer than an untenable government promise to be fulfilled decades in the future.

Retirement security is also enhanced by diversification of risk. Personal accounts would diversify the risk inherent in the Social Security system by allowing individuals to split between political risks (the risk of reductions in government-paid benefits) and financial risks (risk of depreciation of personally-held assets.) Workers demanding absolute security can, through personal accounts, have risk substantially below that of the current system simply by choosing to invest in government bonds.

In short, with a personal account each worker would have a legal right to his benefits and could choose the combination of risk and return to which his age, circumstances and temperament make him most comfortable.

*Finding: Social Security should be extended to include inheritable assets.*

Almost one in five 20-year-olds will not live to age 65. Among African American males, this percentage is even higher. While Social Security offers survivors benefits to spouses who have reached retirement age and to children under the age of 16, Social Security – which constitutes the total saving for many lower-income workers – offers no opportunity for workers to build and pass on any substantial wealth to their heirs, even if the worker died prior to receiving any benefits at all. The only lump sum wealth Social Security provides to pass on is a one-time payment of a \$255 death benefit.

The Commission recommends that Social Security preserve its current system of survivor benefits, but supplement these insurance protections with a system of personal accounts whose assets could be passed on to a spouse or heirs. Inheritable assets would improve Social Security’s treatment of demographic groups with lower incomes and shorter life expectancies and enhance prospects for asset accumulation and wealth-building in underserved communities.

Social Security effectively annuitizes the contributions a worker pays in over the course of his lifetime, converting them from a lump sum of wealth into an entitlement to specified monthly payments for life. This Social Security annuity provides valuable protections against outliving one’s assets, but it also pays the highest lifetime benefits to individuals who live the longest. Since longevity is correlated with income, poorer workers will tend to die younger and therefore receive fewer benefit payments.

<b><i>African Americans Hold Substantially Less Wealth At Retirement</i></b>				
	<b>Total Net Worth</b>		<b>Financial Assets</b>	
Percentile	All	African American	All	African American
10	\$150	0	0	0
20	\$8,000	0	0	0
30	\$28,005	\$700	\$600	0
50	\$77,800	\$17,000	\$8,000	0
70	\$154,000	\$45,000	\$36,000	\$1,000
90	\$384,000	\$114,600	\$152,000	\$11,000
95	\$618,000	\$182,000	\$275,000	\$32,300

Source: James P. Smith, “Wealth Inequality among Older Americans,” RAND Corporation Working Paper Series, 95-06, April 1995, p. 20.

Moreover, since lower-income workers are almost totally reliant upon Social Security for income in retirement, this means they have very little inheritable wealth to pass on to their heirs.

The combination of these two factors can be particularly harmful to African Americans, who on average have both lower incomes and shorter life expectancies than other Americans.

If lower-income workers had the option to receive at least part of their Social Security benefits as a sum of wealth that could be passed on at their death, younger generations might have opportunities to attend college or start a business that would otherwise be unavailable to them. These opportunities would further contribute to an easing of asset inequality in the United States.

*Finding: Strengthening Social Security to include personal accounts can add valuable protections for the segments of American society at greatest risk of poverty in old age.*

Poverty among the elderly tends to be concentrated among women, single individuals, and ethnic and racial minorities. A properly designed individual account program should assist each of these groups.

Widows would be assisted by allowing for inheritable personal accounts in addition to Social Security's current, or a strengthened, widow's benefit.

Divorced persons would be assisted by the establishment, for the first time, of joint property rights in Social Security benefits accumulated during marriages that last for less than ten years.

Single working women would be assisted by the creation of an element that lacks Social Security's current redistribution away from single earners to married couples.

Lower-income groups would be assisted by the opportunity to build financial assets with a portion of the 12.4 percent of their wages that are currently contributed to Social Security.

Demographic groups with shorter life expectancies would benefit from adding inheritable assets to Social Security's current survivors' protections.

*Finding: Partial advance funding of Social Security should be a goal of any effort to strengthen the system.*

This Commission agrees with the unanimous finding of the 1994-96 Social Security Advisory Council that partial advance funding of Social Security benefits is desirable. Advance funding raises national saving, increasing the nation's capital stock and productive capacity and reducing Social Security's financial burden on future generations.

As detailed in our Interim Report, the current system operates primarily as an income transfer program in which every penny of benefits paid each year comes from taxes collected or money borrowed from the public in that year.

Over the next 50 years, the number of workers available to support each Social Security beneficiary will drop from 3.4-to-1 to only 2-to-1. The cost of supporting the current system will increase 69 percent<sup>17</sup> during that period, with a corresponding deterioration in Social Security's equitable treatment of different generations.

To ensure that Social Security's financing burdens are equitably shared, it is imperative that a portion of these revenues be devoted to advance funding. The resulting increase in national saving will raise the country's capital stock, and therefore boost our productivity and output. In essence, increased national saving increases the size of the economic pie that is available for everyone, old and young alike, to consume in the future.

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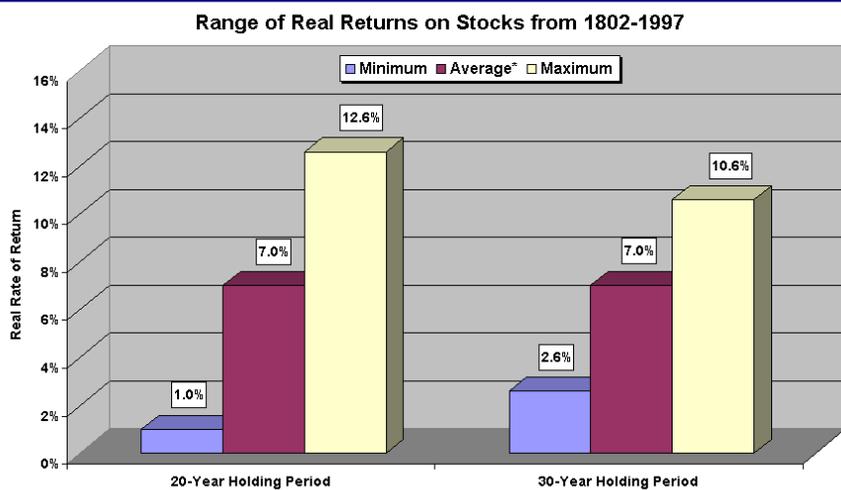
<sup>17</sup> 2001 OASDI Trustees Report (Washington, DC, Government Printing Office), p.44. Intermediate projections show 2001 cost rate of 10.5 and a 2050 cost rate of 17.79.

*Finding: Personal accounts would permit individuals to seek a higher rate of return on their Social Security contributions, offering higher total expected benefits to individuals with accounts than those lacking them. This finding holds true regardless of the other steps taken to balance the traditional system.*

Any properly constructed personal account option should increase expected benefits for Social Security participants. This is true regardless of the overall resources devoted to the program. Under plans that retain the current payroll tax, an individual opting for a personal account can expect higher overall benefits than one who does not choose an account. Similarly, under plans that increase revenues available to the system, individuals opting for a personal account can expect to receive higher benefits than those choosing not to have such an account.

It is relatively straightforward to show that, for a given level of funding, a personal account system can offer higher total expected benefits than the current system. However, confusion occasionally arises when comparisons are made between two different plans that employ different levels of tax revenue. For example, scheduled benefits for the current system could be provided only if significant tax increases are enacted. It is not an equal comparison to assume these tax revenues will materialize for the current system, but not for a specific personal account system. For comparisons to be meaningful, all factors other than the presence of the account must be held constant. When that is the case, individuals with personal accounts can expect higher total benefits than those without.

**For the Past 200 Years, The Stock Market Has Never Lost Money Over 20 Years**



\*Average return is the average annual return over the entire period  
 Source: *Stocks for the Long Run*, by Jeremy Siegel

Going forward, the nation faces a range of choices to bring the existing Social Security system to a path of fiscal sustainability. For purposes of illustration, In Chapter 4, the Commission shows the effects of one approach to balancing the Social Security system without tapping additional tax revenues, as well as the total cost of

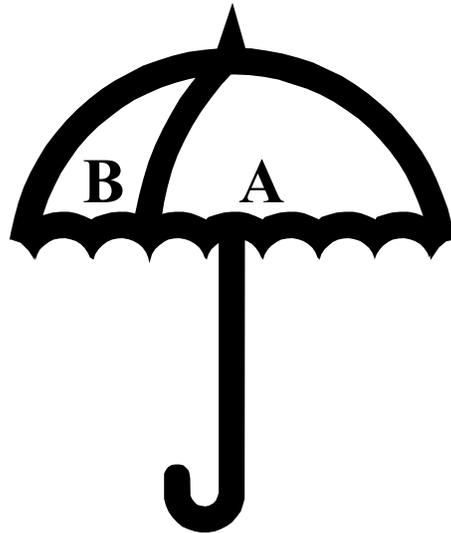
meeting the unsustainable current pace of benefit growth through additional revenues. Regardless of the path chosen by policy makers, the Commission’s projections show that individuals who are given the opportunity to invest in personal accounts should expect increases in total benefits.

The opportunity to receive a higher rate of return derives from the gains that come from returns on capital. Over a working lifetime, the compounding of these returns – sometimes referred to as the “miracle of compound interest” – can make an enormous difference in an individual’s level of wealth. Because of the impact of compound interest, diversified personal accounts can be expected to grow rapidly.

*The Commission recommends that personal accounts augment the Social Security safety net by increasing total benefits relative to what the current system can pay.*

Today, all of a retiree's retirement protections come from the traditional system.

In the future, workers could have the option to receive some of their benefits from a personal account – “Social Security Part B” – while still receiving benefits from the traditional system – “Social Security Part A.” And the total of these two parts will provide greater protections from poverty than the current system can provide.



*Finding: Advance funding within Social Security can best be accomplished through personal accounts rather than direct government investment.*

The Commission agrees that advance funding cannot be reliably accomplished through a Social Security Trust Fund invested wholly by the federal government. While it is theoretically possible to build up a fund in this manner, the past two decades have taught our nation a clear lesson about how unlikely this is in practice. The availability of Social Security surpluses provided the government with an opportunity to use these surpluses to finance other government spending, rather than saving and investing them for the future. A failure to increase national saving means that future taxpayers will bear a higher tax burden without the benefit of the increase in productivity that such saving might have stimulated.

This Commission strongly believes that investment in private securities should be handled through personal accounts rather than direct government investment, for several reasons:

- When people own the personal account assets themselves, the assets are less likely to be diverted for non-Social Security purposes.
- Personal accounts allow every participant to choose an investment portfolio that is consistent with his or her preferences, while central government investment essentially forces everyone into a “one size fits all” portfolio.
- Government investment will likely be subject to pressures for investment based on non-financial criteria, which may threaten account performance. These political forces might lead to intense lobbying and campaign contributions designed to influence investment policy, which would be bad for the government as well as the economy. There are many examples of this occurring in other contexts:

The California public pensions system’s decision to divest its tobacco stocks cost retirees an estimated half billion dollars.

Government investment of pension funds in other countries has resulted in returns averaging below those available from standard bank accounts, according to the World Bank.

The argument over political restrictions over centrally-controlled investment has already begun in the United States. When the Clinton administration suggested investing Social Security reserves in the private market, several union leaders sent a letter to Congress expressing their opposition to investment of such funds in corporations that engaged in practices opposed by the labor unions.

- Government investment of personal accounts could place the government in a position to interfere with corporate decision-making.
- Government investment can lead to serious conflicts of interest. For example, the government would be simultaneously regulating and investing in the same companies, or even filing lawsuits against such companies.

*Finding: The Commission finds that the establishment of personal accounts is likely to lead to an increase in national saving.*

The Commission believes that establishing personal accounts will lead to increased national saving. This would apply under almost any reasonable proposal to establish personal accounts.

The first reason is that, to a first approximation, if the federal government would otherwise save 100 percent of the money that would be saved in personal accounts, then establishing personal accounts would not increase national saving. If the government would otherwise spend such Social Security revenues, then establishing personal accounts would increase net government saving. It is impossible to know with precision the degree to which the federal government would otherwise save Social Security revenues that are to be deposited in personal accounts. The most that can be said is that as a matter of historical record, the government has not tended to save this money. To the extent to which this pattern would continue in the future, saving this money in personal accounts would increase net government saving.

*Finding: The Commission believes that the establishment of personal accounts will improve incentives for labor force participation.*

The nation's ability to support its retiree population is directly related to the ratio of those in the workforce to those in retirement. Accordingly, the maintenance of an adequate supply of labor is a critical element of Social Security reform. However having to pay additional Social Security taxes is a deterrent to work, particularly for those who derive no additional benefit when they pay these taxes.

Numerous studies indicate that Social Security has led to earlier retirement in the US. For instance, Social Security rules impose a large "implicit" tax on labor supply around the Normal Retirement Age, and the tax is high at even younger ages for some workers.<sup>18</sup> Importantly, these implicit taxes on labor are in addition to the tax levied via the U.S. income tax system. High tax rates provide an incentive for individuals to retire rather than to remain in the labor force.

The effect of Social Security on labor supply is not limited to issues relative to the retirement decision. Research suggests that workers do not fully understand the complex linkage between the taxes they pay and the benefits they receive.<sup>19</sup> As a result, the Social Security payroll tax may have the effect of increasing the marginal tax rate faced by individuals working throughout their lives. Since the payroll tax is larger than the income tax for the large majority of U.S. households, the marginal tax rates created by the Social Security system are an important issue.

High tax rates on labor distort both the supply of labor and the form of compensation that individuals receive, resulting in what economists call a "deadweight loss" to the economy.<sup>20</sup> These distortions are a drain on the nation's economy, reducing output and growth and making it that much more difficult to finance the provision of future retirement benefits.

Relative to the current system, contributions to personal accounts are less likely to discourage work. Personal account contributions are less likely to be viewed as a tax, because the money is deposited into an account that is owned by each system participant. Because workers perceive a direct link between the contributions and future benefits, their labor supply decisions throughout their work life are less likely to be distorted.<sup>21</sup> Near retirement, workers may perceive that accumulations in their accounts will grow, and the annuities they can purchase will increase, if they work and contribute

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<sup>18</sup> Peter Diamond & Jonathan Gruber "Social Security and Retirement in the US" NBER WP 6097 July 1997 p. 24. Courtney Coile and Jonathan Gruber, "Social Security Incentives for Retirement," in Themes in the Economics of Aging 2001.

<sup>19</sup> Alan Gustman & Tom Steinmeier "What People Don't Know About Their Pensions and Social Security: An Analysis Using Linked Data from the Health and Retirement Survey, NBER WP 7369, September 1999.

<sup>20</sup> A deadweight loss is a reduction in social welfare that has no corresponding gain. Martin Feldstein & Jeffrey Liebman "Social Security" NBER WP 8451, forthcoming in Handbook of Public Economics.

<sup>21</sup> Lawrence H. Summers, "Some Simple Economics of Mandated Benefits, American Economic Review; 79(2), May 1989, pages 177-83.

longer. This may encourage them to stay in the labor force – an incentive that becomes particularly important as Baby Boomers retire.

## **Chapter 2: Administration of Personal Accounts**

### Summary of Findings

*Personal accounts can be administered in an efficient and cost effective manner.*

*The adoption of a “mixed” two-tier structure most effectively balances the desire for low administrative costs along with consumer choice and efficient financial markets.*

*The Governing Board should investigate ways to reduce the time that it takes to credit contributions to personal accounts, without increasing employer compliance costs.*

*Investment allocations should be allowed to be changed not more than once during a 12-month period; but access to account information should be immediate.*

*The Governing Board must bear the primary responsibility for providing participants with the necessary financial information. Non-profit organizations are encouraged to continue their efforts in this area.*

*Participants in Tier I should be able to choose one of three indexed balanced funds (conservative, medium, and growth) or any combination of five index funds, patterned after the current TSP funds, as well as an inflation-protected bond fund.*

*A standard fund should be established for those individuals who do not select a fund in Tier I.*

*Private-sector account administrators in Tier II may offer the same funds as in Tier I, and possibly other broadly diversified mutual funds certified by the governing Board according to appropriate criteria.*

*Pre-retirement access to funds in personal accounts should not be allowed; accounts may be bequeathed by those who die before they receive retirement benefits.*

*At retirement, personal account distributions should be permitted to be taken as an annuity or as gradual withdrawals, and balances above a threshold can also be taken as a lump-sum distribution. The threshold amount should be chosen so that the yearly income received from an individual’s defined benefit plus the joint (if married) annuity keeps both spouses safely above the poverty line during retirement, taking into account expected lifetimes and inflation.*

*All account balances attributable to contributions during marriage, and all earnings on account balances brought into marriage, should be divided equally in the event of divorce. Account balances brought into marriage would not be shared.*

*Upon retirement, a joint and survivor two-thirds annuity (as under Social Security) should be required unless both spouses agree to an alternative arrangement.*

*To isolate the Governing Board from political risk, Congress should follow the models of the Thrift Savings Plan and the Federal Reserve Board when designing the Board structure.*

*Equity shares in the mixed system should be voted by fund managers.*

## *Background*

The Commission sought to determine whether personal accounts could be implemented in a cost-effective manner that give Americans a good value for the services they receive. We have concluded that personal accounts can be administered in an efficient and effective manner. Non-partisan experts in Executive Branch departments helped in the evaluation of design options for personal accounts.

*Finding: Personal accounts can be administered in an efficient and cost effective manner.*

International experience is consistent with this finding. More than 20 countries spanning five continents have now created personal accounts to either augment or replace their public pension systems. Personal accounts have been created in a diverse set of countries including Argentina, Australia, Chile, Hong Kong, Mexico, Poland, Switzerland and the United Kingdom. Numerous other countries, including Russia and China, are also now in the process of creating personal accounts. Even Sweden – a country traditionally offering a large amount of publicly provided welfare – has also recently added personal accounts to its public pension program. Experience in the United States with 401(k) plans and Individual Retirement Accounts<sup>22</sup> has given U.S. financial providers a tremendous amount of experience in administering personal accounts. The United States – the country whose approach to Social Security was copied throughout the world during the 20th century – is now behind in modernizing its social security system for the 21<sup>st</sup> century.

Both the international experience and the Commission's own examination have provided two valuable lessons. First, personal accounts can be administered in a cost-effective fashion. Second, the design details are important. The United Kingdom's system, for example, has been criticized for high administrative costs and 'account churning.' The U.K. government has recently re-reformed this system to help solve these problems.

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<sup>22</sup> Individual Retirement Arrangements (IRAs) are also sometimes referred to as "Investment Retirement Accounts."

## *The General Structure of Personal Accounts*

Personal accounts can be structured in several different ways. The ideal administrative structure must balance several goals. First, administrative fees must be reasonable and proportional to the services that are provided to the owners of personal accounts. Second, investment choices must be designed to reduce the risk for individual account holders, especially for those who currently do not participate in financial markets, by requiring that investments be made in broadly diversified portfolios. Third, workers and retirees must be given some flexibility in the choice of personal accounts that they own in order to realize the benefits of competition. Fourth, personal account owners are entitled to have their contributions credited to their personal accounts in a timely and accurate fashion, but without imposing additional compliance costs on employers. Fifth, the government must be diligent in ensuring that any personal account system is operating efficiently and fairly.

At one end of the administrative structure spectrum, is the so-called “centralized” approach. Under this approach, payroll collections are transferred to a government-appointed central administrator using the existing Social Security payroll tax system. Workers have a choice among a limited number of low-cost, diversified investment indexed funds, like under the Thrift Savings Plan (TSP), which is a retirement plan for many federal and military workers. The central administrator keeps all records and invests worker contributions according to their preferences. These indexed funds purchase stocks in numerous companies and the amount invested in each company is proportional to the company’s value relative to that of other companies in the fund. Like TSP, a Governing Board contracts fund management to multiple private managers on a competitive basis.

The centralized approach is sensible to implement in the short term but is probably not the best approach in the long run. The centralized approach does not incorporate the market discipline that might be necessary to provide workers and retirees with good value and choices. Consumers who are unhappy with their fund manager could not “vote with their feet” by moving to another provider. De-regulation in the telephone industry and the airline industry provide ample evidence that consumers like choice even for relatively homogenous products and that choice generally leads to lower prices and better services. A “one-size-fits-all” approach, therefore, is not the best approach.

At the opposite end of the administrative spectrum is the “decentralized” approach. One version of this approach includes existing 401(k) programs that are offered by many large and medium-size employers. Under this approach, payroll collections are transferred directly from employers to private-sector investment funds that satisfy diversification and other requirements. Workers make investment choices through their employers, and workers can choose from a wide range of private-sector funds, switching funds if they so desire. The government must still interact with each fund and employer in order to enforce compliance.

The decentralized approach, though, faces its own problems. First, the cost of compliance would increase for employers that do not currently offer 401(k) programs, including many small employers. Even those companies that do offer 401(k) programs often use only one fund complex; in the decentralized approach, some workers might wish to invest in a fund from a different complex. To prevent compliance costs from increasing, employers must be allowed to continue to submit contributions through the existing payroll tax system, which requires some centralization. Second, some standard fund must be available to those who do not make a selection. Third, close to 28 million Americans in the year 2000 had wages and salaries below \$5000. Many of these people are students and teenagers who will earn larger incomes in the future, but even small transaction fees could be large relative to account balances for many people, an unacceptable outcome. While caps on transaction fees could be used to pool administrative costs across participants, such caps could also stifle innovation.

*Finding: The adoption of a “mixed” two-tier structure most effectively balances the desire for low administrative costs along with consumer choice and efficient financial markets.*

The Commission recommends the adoption of a “mixed” two-tier structure that adopts the best features from both the centralized and decentralized approaches. Under the mixed approach, collections are transferred to a central administrator using the existing payroll tax system. The central administrator verifies that the correct amount of contributions is submitted for each worker. Investments for each employee are made through the central administrator (as in the centralized plan). Initially, all collections are invested into “Tier I” of the program. In Tier I, workers choose from a range of funds that are currently offered by the Thrift Savings Plan, plus three additional balanced funds and an inflation-protected bond fund discussed below. When employees have accumulated a threshold account balance (say, initially, \$5000), however, they are allowed to invest that threshold balance plus subsequent contributions in a range of “Tier II” qualified private-sector funds. Multiple private-sector funds are allowed but they must satisfy stringent rules as determined by the Governing Board. The funds must be very diversified and reflect the performance of many companies spanning all major commercial sectors. Moreover, the share of the fund invested in each corporation cannot exceed strict limits as established by the Governing Board.<sup>23</sup> The Governing Board chooses the threshold amount that is required for people to move their balances into Tier II so that it would be feasible for such accounts to be charged low transaction costs without the need for price caps. Within 3 years after the creation of personal accounts, the Governing Board must produce a plan that is necessary for Tier II to be fully functional; within 5 years, it must implement the rules and administrative support, including personnel, hardware and software, for Tier II.

Funds in both Tiers cannot charge sales “loads” or other marketing fees on entry or exit. Instead, all fees must be included in one annual charge and clearly stated as a percentage of assets. These restrictions provide added protection to low-income workers. Fund selection is made through the central administrator, which will list key information about each fund, as determined by the Governing Board, including fees. Competition, on the basis of past fund performance, along with information provided by the Governing Board, will provide participants with a basis for comparison and choice in both Tier 1 and Tier 2. The Governing Board must have broad authority to provide workers with informative advice, and to implement reasonable changes in either Tier that it believes is in the best interest of workers and retirees. It must also be able to make recommendations to Congress on larger, structural changes that the Board believes is necessary to make the system more efficient.

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<sup>23</sup> With “passively managed” funds, the amount of stock that is invested in any particular corporation is simply based on the market value of that corporation relative to others in the index. “Actively managed” funds, though, require more investor judgment by fund managers who try to pick under-valued companies. Since funds must be broadly diversified, the practical distinction between passively managed and actively managed funds is diminished.

*Finding: The Governing Board should investigate ways to reduce the time that it takes to credit contributions to personal accounts, without increasing employer compliance costs.*

Using the current payroll contribution system, it would take about 15 months on average before payroll contributions are credited to personal accounts. This delay is known as the “reconciliation period.” This reconciliation period is much longer than that in private-sector 401(k) plans. The reason for the difference is that, while firms send employee taxes to the government throughout the year,<sup>24</sup> firms do not actually identify the employees for whom the tax payments are made until the end of the year. Since many smaller firms file their returns on paper rather than electronically, it then takes the government several additional months to process this information.<sup>25</sup> We propose that the aggregate pool of contributions be invested in government bonds until information on contributions by individuals is reconciled with aggregate employer payments.<sup>26</sup> Personal accounts are then credited with the contribution amount and the bond yield earned during this reconciliation period.

While shortening the reconciliation process would allow people to more quickly invest in higher-yielding assets, the Commission does not recommend any immediate change in the current reconciliation process for two reasons. First, since 1978, firms have not been required to identify employees in their tax reporting until after the end of the year in order to keep reporting costs to a minimum.<sup>27</sup> Personal account administration should not, therefore, add any burden to small employers. Second, quicker reconciliation would have little actual effect on the retirement benefits of most people. A person who wishes quicker access to stocks could simply hold more stocks using their previously reconciled contributions, or using assets held outside of the new personal retirement saving accounts.<sup>28</sup>

The Governing Board should, however, investigate ways of accelerating the reconciliation process without imposing higher costs on employers. Faster reconciliation could increase confidence in the personal account system by allowing employees to

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<sup>24</sup> Even here, though, firms differ significantly in how frequently they pay taxes. Very large firms pay daily while smaller firms pay quarterly. Many self-employed workers pay taxes annually.

<sup>25</sup> On average, the initial postings of employee earnings (W2 records) are 99% complete nine months after the end of the relevant liability year (seven months after Form W-2's are required to be filed with the government). Thus, contributions would be, on average, held 15 months before posting (e.g., contributions collected in January 2001 would be 99% posted by September 2002). The initial posting of self-employed earnings (Schedule SE) are 99% complete one year and nine months after the end of the relevant liability year (eleven and a half months after reports are required to be filed with the government).

<sup>26</sup> This process effectively happens automatically throughout the tax year, as the government changes its debt issuance with tax receipts on a fairly continual basis. Hence, no extra mechanism is necessary here.

<sup>27</sup> Beginning in 1978, firms were no longer required to engage in quarterly reconciliation of their tax payments with the employees for whom the payments were made. The change to annual reconciliation was instituted in order to reduce the costs on both employers and the government by allowing employers more time to identify and correct errors before reporting.

<sup>28</sup> Only young people with no outside assets and who wish to hold only stocks would feel ‘constrained’ by slower reconciliation. However, the impact on their welfare from having to hold bonds in place of even more stocks for a short duration would be small.

quickly verify that their contributions have been invested. Many firms are already capable of being able to match tax contributions to their employees on a quarterly basis. These firms would have the incentive to offer this service as a benefit to their employees, provided that the central administrator, in turn, credited personal accounts in a timely manner.<sup>29</sup>

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<sup>29</sup> One option may be to expand the Electronic Federal Tax Payment System (EFTPS) to allow for matching of tax payments to employees.

*Finding: Investment allocations should be allowed to be changed not more than once during a 12-month period; but access to account information should be immediate.*

Personal retirement accounts are intended to supply retirement income and, therefore, should encourage people to think long term about their investments. Personal accounts should not encourage shortsighted activities such as “day trading” or “market timing” that simply lead to higher transaction costs for most people. We, therefore, recommend that changes in investment allocations be limited to once a year. Account statements should be mailed annually and reflect the newest investment allocations. Investment returns must be credited to the account on a daily basis. Moreover, account balance information must be accessible at any time through the Internet or automated calling. The efficiency of this system must be diligently monitored by the Governing Board, which must be empowered to make changes to the system. The enabling legislation should require that the Governing Board seek congressional approval only for larger, structural changes.

*Finding: The Governing Board must bear the primary responsibility for providing participants with the necessary financial information. Non-profit organizations are encouraged to continue their efforts in this area.*

Financial information must be distributed to people with personal retirement accounts. Indeed, one of the exciting outcomes of creating personal accounts is that it will give people who do not currently have personal retirement accounts the incentive to increase their financial understanding, which could encourage them to save more in general. The Governing Board, employers, or fund administrators could provide financial information, as could non-profit organizations. However, we believe that the primary responsibility lies with the Governing Board, possibly with assistance from the Securities and Exchange Commission. Utilizing the Governing Board will reduce compliance costs on employers. Moreover, people will have confidence that the provided information is objective, and the quality of financial education will not differ between employers.

### *Investment Choices*

Personal account investment options must be designed to ensure that people invest in a broadly diversified portfolio of corporate stocks, corporate bonds and government bonds so that they can achieve the best possible returns with a reasonable amount of market risk. Moreover, if workers are not comfortable making choices among various options, they should be provided with a balanced standard fund.

*Finding: Participants in Tier I should be able to choose one of three indexed balanced funds (conservative, medium, and growth) or any combination of five index funds, patterned after the current TSP funds, as well as an inflation-protected bond fund.*

In Tier I, participants will be able to choose between investing their contributions in a balanced fund or any combination of the five index funds that are currently offered by the Thrift Savings Plan for federal workers. Fund management services would be auctioned off to several private-sector providers in order to provide low fees and to avoid any single fund manager holding too much money.

A balanced fund is invested into a certain percent of corporate stocks, corporate bonds and government bonds. A conservative balanced fund holds a relatively larger amount of government and high-grade corporate bonds, while a growth balanced fund holds a higher proportion of stocks. The holdings of the medium balanced fund fall between the conservative and growth funds. The stock fund itself must also be very diversified and reflect the performance of many companies spanning all major commercial sectors.<sup>30</sup> The Thrift Savings Plan includes several funds: the Government Securities Investment (G) Fund; Fixed Income Index Investment (F) Fund; Common Stock Index Investment (C) Fund; Small Capitalization Stock Index Investment (S) Fund; and the International Stock Index Investment (I) Fund.<sup>31</sup> In addition to these funds, the government should create an Inflation Protected Bond Fund that allows participants to invest in Treasury Inflation Protected Securities (TIPS). TIPS allow participants to protect the purchasing power of the wealth that they have accumulated in their personal accounts.

The diversification requirement for stock holdings helps minimize the impact that any single corporate stock or commercial sector has on the total return to the qualified fund. A fund that, therefore, is heavily weighted in the stock of a particular corporation or sector would not qualify. While the U.S. capital market currently allows for a large amount of diversification, the Governing Board should study how international stocks provide additional diversification for participants.

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<sup>30</sup> Examples include the Standard and Poor's 500 Index, which includes 500 of the most widely held U.S.-based common stocks, chosen by Standard and Poor for market size, liquidity, and sector representation. The Wilshire 5000 Total Market Index represents the broadest index for the U.S. equity market. It includes the performance of all U.S.-headquartered equity securities (now more than 7,000 with readily available price data).

<sup>31</sup> The G Fund specializes in short-term U.S. Treasury securities issued solely to the TSP. The F Fund strives to match the returns of the overall U.S. bond market. The C Fund holds large-company stocks and tracks the Standard & Poor's 500 Index. The S Fund consists of medium- and small-company stocks, which tracks the performance of the Wilshire 4500 stock index, now consisting of over 6000 companies. The I Fund is invested in a diverse set of major corporations located in Australia, Europe and the Far East.

*Finding: A standard fund should be established for those individuals who do not select a fund in Tier I.*

For those individuals who fail to choose a Tier-I fund, their contributions must be invested into a *standard fund* on their behalf. Empirical evidence suggests that many participants in private-sector 401(k) plans also base their investment decisions on the design of the standard fund.<sup>32</sup> It is likely, therefore, that many participants will look to the standard fund as a benchmark for their own investment decisions in a Social Security system augmented with personal accounts. The standard fund, therefore, must be chosen appropriately. If the standard fund, for example, is too conservative by holding mostly bonds, then some participants will not be able to enjoy the higher expected returns from a fund with more stocks. At the same time, the standard fund must be appropriate for the participant's age, as younger people should invest relatively more in stocks. The growth balanced fund discussed earlier, therefore, would be an appropriate standard fund for young workers; the medium fund for middle-age workers; the conservative fund for older workers. However, the standard fund must also be consistent with any promises that are made with respect to personal accounts. If the government, for example, promises that the personal accounts will produce a minimum return or benefit, provided that the personal account is invested in a particular balanced fund, then that fund should be the standard.

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<sup>32</sup> James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "Defined Contribution Pensions: Plan Rules, Participant Decisions and the Path of Least Resistance," Forthcoming in NBER Tax Policy and the Economy, 2001.

*Finding: Private-sector fund managers in Tier II may offer the same funds as in Tier I, and possibly other broadly diversified mutual funds certified by the governing Board according to appropriate criteria.*

Upon reaching a threshold amount in their personal accounts in Tier I, participants can invest that threshold balance and subsequent contributions with a private-sector provider. Private-sector funds, therefore, provide competition and choice, thereby preventing a government monopoly over fund design. Tier-II funds, though, must meet very strict diversification requirements as established by the Governing Board. Other requirements might include registration with the U.S. Securities and Exchange Commission or appropriate banking/insurance regulator and other standards established by the Governing Board. Stock funds must be very diversified and reflect the performance of many companies spanning all major commercial sectors. Moreover, the amount of the fund invested in any particular corporation must not exceed strict limits as established by the Board. Some leeway must be given in order to allow firms offering funds to innovate and to provide a reasonable level of choice. All innovation, however, must be partly constrained by the need for all stock funds to hold a diverse set of assets.

#### *Access to Funds in Personal Accounts*

The access of funds in personal accounts that should be allowed must balance several important goals. First, workers should not be allowed to consume funds in their personal accounts in such a manner that would leave them impoverished during retirement and then dependent on the government for additional resources. While personal accounts are intended to provide workers with ownership over real assets, it is important to remember that ownership engenders certain responsibilities, including not being allowed to impose additional costs on taxpayers. Second, people with below-average life expectancies, including the lifetime poor, must no longer be forced to contribute too much during their working years exclusively to a retirement system from which they will receive few annuity benefits upon retirement. Personal accounts must provide a variety of withdrawal options at retirement, including the ability to leave some assets to loved ones upon death. This bequest option is currently missing from Social Security.

*Finding: Pre-retirement access to funds in personal accounts should not be allowed; accounts may be bequeathed by those who die before they receive retirement benefits.*

While prohibiting pre-retirement access might seem very restrictive at first glance, it is important to recognize that even among people facing difficult circumstances during pre-retirement years, most are still expected to spend some years in retirement. Difficulties in pre-retirement years do not justify facing even greater difficulties during retirement due to a lack of resources. While some people might suggest that accounts should be accessible in some “hard cases” (e.g., disability) we believe that those needs are best handled with other government policy, and not with funds set aside for retirement. Furthermore, allowing for pre-retirement access in the “hard cases” potentially opens Pandora’s Box for less discriminating account access in the future. In the same way that Social Security benefits cannot be accessed before retirement or used as collateral for a loan, neither should assets held in personal accounts be available for other purposes.

However, unlike Social Security, assets held in personal retirement accounts can be bequeathed to heirs if the account owner dies before retirement. In this way, wealth accumulation in the family need not be cut short with the death of the primary earner.

*Finding: At retirement, personal account distributions can be taken as an annuity or as gradual withdrawals, and balances above a threshold can also be taken as a lump-sum distribution. The threshold amount is chosen so that the yearly income received from an individual's defined benefit plus the joint (if married) annuity keeps both spouses safely above the poverty line during retirement, taking into account expected lifetimes and inflation.*

The primary purpose of personal retirement savings accounts is to provide retirement income and wealth that can be passed on to family members and heirs. Pensioners, therefore, should not extract all of their resources at the point of retirement and then depend on government programs for additional retirement income (e.g., the Supplemental Security Income [SSI] program). Instead, individuals should have an immediate right to their money only to the extent that they can continue to support themselves.

People with personal accounts should, therefore, be required to take at least some of their money as an annuity or as gradual withdrawals. An annuity pays a fixed stream of money until the person dies. The Governing Board is required to make available different types of annuities, including inflation-indexed annuities that automatically incorporate protection against inflation; standard annuities without that automatic protection would have to pay more in terms of purchasing power early in retirement in order to protect against poverty later in retirement. Other forms of annuities incorporate the ability to leave a bequest if the holder dies before a certain length of time. A gradual withdrawal plan allows people to receive back their money bit by bit over their expected remaining lifetime. Any money left at death can be fully bequeathed. But because it is not an annuity, there is a chance that the person will outlive their resources. The withdrawal schedule, therefore, must be chosen to be long enough in order to cover the expected lifetimes of the retiree and spouse, and to maintain purchasing power, given the probable rate of inflation.

Only when it can be reasonably assured that retirees can enjoy retirement outside of poverty will they be allowed to take money from their accounts as lump-sum payments. Some observers, though, might object to this restriction on the grounds that people should be allowed full access to their funds if they can prove that they have other private resources that they can use in order finance retirement. There are several discrepancies, however, with this argument of considering outside resources. First, if people have additional resources to consume, then they can simply consume those resources first; they don't need to first consume assets from their personal retirement accounts. Second, the government cannot prevent people from consuming resources from other sources and then qualifying for additional income subsidies (e.g., SSI). Third, verification of outside resources would require a new, costly and intrusive administrative governmental structure. Fourth, allowing wealthier people greater access to their personal retirement savings account seems like a regressive policy.

### *Protection of Spouses*

In many marriages, one of the two partners takes on a less active role in the formal labor market in order to devote time and energy to maintain the home and family. Traditionally, women have performed these vital duties by either completely exiting the labor market or taking lower-paying jobs, while men have remained in the workforce. Upon divorce or death of the primary earner, many spouses, therefore, have been left with few assets. Moreover, they often have little opportunity to acquire more assets as they face a hard time re-entering the workforce, since the skills that they acquired before marriage are now outdated.

Former spouses and survivors, therefore, must be protected under any personal retirement account program. First, divorce too often spells the beginning of financial insecurity for spouses with a limited work history. Personal account ownership, therefore, must help provide former spouses better protection relative to Social Security and provide them with a fairer sharing of assets that recognizes their contributions to the household. Second, widows and widowers today too often fail to live in financial security during retirement. Personal account ownership, therefore, must help provide better protection to survivors.

*Finding: All account balances attributable to contributions during marriage, and all earnings on account balances brought into marriage, should be divided equally in the event of divorce. Account balances brought into marriage would not be shared.*

Social Security currently recognizes that some spouses may contribute more towards fostering a positive home environment, choosing to earn less outside of the home. Consequently, a spouse has the option of either claiming a retirement benefit based on his or her own work history or a benefit equal to one half of that of his or her spouse. In the event of divorce, spouses continue to be eligible for this benefit option if the marriage has lasted ten or more years.

Most marriages, though, last less than ten years, leaving low-earning spouses ineligible for a Social Security spousal benefit and, therefore, uncompensated for years spent either out of the labor force or working in a limited capacity. In addition, Social Security requires a divorced spouse to be unmarried to qualify for retirement benefits based on the former spouse's social security record, thus nullifying these Social Security claims in the case of remarriage, regardless of how long the marriage may have lasted.

We, therefore, recommend protecting low-earning spouses by mandating that both spouses' account growth be shared equally in the case of divorce.<sup>33</sup> Spouses whose marriages have lasted longer period of time, and hence have given up more by being absent from the job market, will benefit more by sharing in the larger earnings on all account balances. Only initial balances brought into the marriage are not shared.

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<sup>33</sup> Account balances accrued prior to marriage are not shared because of the complications and potential inequity of splitting balances if such a policy were to be applied to a person having had multiple marriages/divorces.

*Finding: Upon retirement, a two-thirds joint and survivor annuity should be required unless both spouses agree to an alternative arrangement that is consistent with the distribution rules discussed earlier.*

Social Security currently requires married couples to receive a joint and survivor annuity at retirement. The annuity is 'joint' because it protects both spouses from outliving their resources by continuing to pay income until both spouses die. Social Security pays a survivor two-thirds of the previous household benefit after a spouse dies provided that the secondary-earner qualified for Social Security based on the earnings of his or her spouse. (The reduction in benefit is not larger because household expenses typically decrease by less than fifty percent when one of the spouses dies.) If, however, both spouses qualified for Social Security based on their own earnings, then the household could lose up to half of their combined benefit. We recommend that a two-thirds joint and survivor annuity should be required unless both spouses agree to an alternative arrangement that is consistent with the findings in the last section. For example, some spouses may not want to fully annuitize their personal account balances in order to be able to leave assets to their loved ones.

*Finding: To isolate the Governing Board from political risk, Congress should follow the models of the Thrift Savings Plan and the Federal Reserve Board when designing the Board structure.*

The Governing Board should be structured with one overriding goal in mind—to ensure that the personal accounts system is administered so as to maximize value to participants. Achieving that goal requires that the governing Board be insulated from political pressures as much as possible.

One model for a Governing Board is found in the Thrift Savings Plan (TSP). The TSP is headed by five part-time Board members appointed by the President, including a chairman with a 4-year term; two members with 3-year terms that are chosen in consultation with the House and the Senate, respectively; and two members with 2-year terms. The TSP Board's has a strict fiduciary responsibility to holders of individual TSP accounts. Neither the Congress nor the President controls the Board's budget. The Board appoints a full-time Executive Director who serves as chief executive officer. Each of these six fiduciaries is required to act solely in the interest of plan participants and must have substantial experience, training, and expertise in the management of financial investments and pension benefit plans. These safeguards have helped ensure that the TSP remains unwavering to outside political pressures.

Another possible model for a Governing Board is the Federal Reserve (FR) Board, the entity that controls the U.S. Federal Reserve System. This Board is made up of seven members that are appointed by the President and confirmed by the Senate, each with a 14-year term. Opportunities for new Board appointments arise only once every two years. Like the TSP Board, the FR Board has a funding source that is independent of Congress and the President. The long staggered terms for FR Board members arguably give the Board even greater insulation from politics than has the TSP Board.

In contrast, investments made by public sector pension plans have often been manipulated by political pressures. Appointments to pension boards in many states and countries often include ex-officio members and other appointees serving at political behest. In pension plans for state and local employees in the United States, for example, state boards have demonstrated a preference for in-state investments and have avoided investments in socially unpopular companies, rather than maximizing financial returns for participants. State boards have even adjusted plan accounting practices so that contributions fluctuate for budgetary reasons unrelated to the pension system's needs. Internationally, government-ran pension plans face similar problems, including a home-bias in investment choices and the use of investments as social policy. Evidence indicates that these pension plans have earned markedly inferior rates of return, due to government intervention.<sup>34</sup>

Public sector pension plans are much more susceptible to political influence than the TSP or FR model because benefit liabilities in public pension systems are not directly

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<sup>34</sup> Augusto Iglesias and Robert Palacios, "Managing Public Pension Reserves – Part I: Evidence from the International Experience," Pension Reform Primer, The World Bank, January 2000.

linked to the investment performance of the public pension's reserves (or 'trust fund'). Instead, benefits are typically based on a worker's previous wage earnings. As a result, politicians can invest in socially popular enterprises while claiming that they are not placing the benefits for current voters in direct jeopardy. Inferior returns instead accrue as a hidden liability on future taxpayers, with only a possible imperfect link to reduced future benefits to those alive today. In sharp contrast, a restriction on investments held in personal accounts would directly reduce the expected retirement benefit of personal account owners. Since the cost of political interference is much more explicit and directly applicable to owners of personal accounts, the temptation for political interference is significantly reduced.

*Finding: Equity shares in the mixed system should be voted by fund managers*

When people buy company stock directly, they become part owners of the company and gain a legal right to help determine the direction of the company, including its investment and marketing decisions. However in the case of investors in a mutual fund, the fund managers almost always directly vote the proxies of the fund. We recommend that the fund managers vote the equity shares for Tier I and Tier II, as under the Thrift Savings Plan today. Fund managers have a legal fiduciary obligation to vote their shares to the benefit of plan participants. Fund managers are in the best position to utilize the vote to further the financial interests of fund participants. While, in theory, the Governing Board could vote the shares in Tier I, we are concerned that they might face undue political influence in terms of their appointments or term renewals. Another option would be not to vote the shares in Tier I at all (or, equivalently, vote them in proportion to the other shares). To be sure, this approach would likely produce efficient business decisions as well. However, we are concerned that, if personal accounts someday become large enough, a minority of shareholders (possibly the directors and officers in the firm) could gain controlling interest in some firms in which they would not otherwise hold a controlling interest.

## **Chapter 3: Achieving a Fiscally Sustainable Social Security System**

### *Summary of Findings*

*The Commission recommends that there be a period of discussion, lasting at least one year, before legislative action to strengthen Social Security.*

*Action should be taken soon to place Social Security on a fiscally sustainable course.*

There are many paths to fiscal sustainability. All of them require some combination of changing the rate of benefit growth or committing additional revenues generated by taxation or by the proceeds of investment.

*Social Security proposals should be evaluated using several important measures of fiscal sustainability.*

*Transition investments in personal accounts are not “costs,” but investments in a fiscally sustainable Social Security system.*

*Personal accounts can reduce the long-term cost growth of the Social Security system, thus contributing to fiscal sustainability.*

*It is not necessary to change benefits for current or near-term retirees.*

*Benefits can continue to grow at least as fast as inflation within current Social Security system tax levels.*

## ***The Fiscal Problems Facing Social Security***

The Commission's Interim Report explained in detail the origin, scope, and extent of the problems facing the current Social Security system. As an income transfer program, Social Security's financial health is sensitive to demographic changes determining the ratio of contributors to recipients. In particular, increasing life expectancies and a decline in birth rates have contributed to a gradual "aging" of the population, reducing the number of workers available to support each beneficiary.

When the United States had a rapidly growing workforce supporting a small elderly population, Social Security seemed sustainable. For instance, in 1960, there were more than five workers paying into Social Security for every individual collecting benefits. However, the burden placed on individual workers increases when fewer new workers are paying into Social Security and a larger population of beneficiaries is collecting from it. Already, demographic changes have reduced the worker-to-beneficiary ratio to 3.4-to-1. By 2050 it will be just 2-to-1. In other words, the relative burden on a worker in 2050 will be two-and-a-half times larger than the burden on a similar worker in 1960.

As a result of these trends, beginning in 2016, Social Security will collect less in tax revenues than needed to pay full promised benefits. Between 2016 and 2038, Social Security will redeem bonds held in its Trust Fund make up the difference, requiring that the U.S. Treasury find the resources to redeem these bonds. These resources must come from higher taxes, public borrowing, or reductions in other spending programs. Social Security's deficits start small but grow rapidly, reaching \$318 billion in 2035 (in 2001 dollars). The cost of paying benefits will rise from 10.5 percent of taxable earnings today to almost 18 percent in 2035.

Absent Congressional action, the Trust Funds will be exhausted in 2038. At that time, Social Security system's dedicated revenue will be enough to cover only 74 percent of promised benefits. To pay full promised benefits would require an increase in the total tax rate from payroll and benefit taxation from the current 12.4 percent to 17.8 percent. By 2075, the tax rate necessary to fund full promised benefits would equal 19.4 percent of payroll, a 57 percent increase over today's payroll tax rate.

Social Security's fiscal problem exists independently of the debate over whether personal accounts should be part of a reformed system. With or without personal accounts, policymakers must answer a fundamental question: *How much of the nation's output should be spent on government support of senior citizens?* Those who believe that the share devoted to the elderly should continue to consume a larger and larger share of the nation's output have a responsibility to identify where the money will come from. Those who believe that growth in spending should be restrained have a responsibility to explain exactly how they would change Social Security's benefit structure to achieve this.

## ***Fiscal Sustainability Findings***

*Finding: The Commission recommends that there be a period of discussion, lasting at least one year, before legislative action to strengthen Social Security.*

Social Security is necessarily complex, touching on many aspects of individuals' lives and doing so over the course of generations. Action to strengthen and modernize Social Security is much needed – but it should not be undertaken in haste. Congress, the President and the public should take the time necessary to consider the consequences of the options under consideration, as well as the consequences of inaction. The Commission hopes that its efforts will be useful in this regard. Nevertheless, after this period of national discussion, steps should and must be taken to keep the President's charge to strengthen Social Security for today's seniors and generations to come.

*Finding: Action should be taken soon to place Social Security on a fiscally sustainable course.*

In the very near term, Social Security's finances are strong, with cash flow surpluses expected for the next fifteen years. By acting now, lawmakers have an important opportunity to address the program's long-run financing problems while more options are available. The existence of short-term surpluses makes it easier to finance a transition to a more sustainable system, while still maintaining our commitment to current and near-term retirees.

The financing problem facing Social Security will not go away. A failure to act will only make the problems facing the system more difficult to address. It is true that there are no easy solutions to the financial problems facing Social Security, but it is equally true that a failure to act will only serve to make the solutions more difficult to achieve down the road.

In summary, the longer that action to strengthen Social Security is postponed, the more certain it is that necessary measures will include painful benefit reductions or tax increases.

*Finding: There are many paths to fiscal sustainability. All of them require some combination of changing the rate of benefit growth or committing additional revenues generated by taxation or by the proceeds of investment.*

Despite the complexity of Social Security benefit and tax rules, the financing problem facing the program is really quite simple. The projected growth in system revenues is insufficient to cover the projected growth in benefits.

Conceptually, the solution to this problem is equally simple. Either revenues dedicated to Social Security must increase faster than currently scheduled, or traditional benefits must grow more slowly than currently scheduled, or some combination.

The need for tough choices to restore fiscal sustainability is real, and it exists independently of whether personal accounts are part of the solution or not. Those who oppose personal accounts must choose between increasing taxes or slowing benefit growth while providing participants with no opportunities to strengthen their retirement security in other ways.

Whatever path to fiscal sustainability is chosen, voluntary personal retirement accounts offer individuals the opportunity to pursue higher expected returns by investing in a low cost, diversified portfolio. As such, even though personal accounts do not eliminate the need for tough fiscal choices, they do provide individuals with an opportunity to pursue higher rates of return, and therefore provide higher expected benefits, than the same system without accounts.

*Finding: Social Security proposals should be evaluated using several important measures of fiscal sustainability*

In accordance with the Executive Order establishing this Commission, the Commission developed a number of criteria for assessing reform proposals. One of these criteria is “movement of the Social Security system toward a fiscally sustainable course that reduces pressure on the remainder of the federal budget and can withstand economic and demographic changes.” This section describes several measures that the Commission uses to identify improvements in system sustainability, along with a discussion of the strengths and limitations of each measure. In practice, we propose that all reform plans be scored along each of these dimensions, so that the tradeoffs between the outcomes can be assessed and evaluated in a clear and comparable form.

*1. Positive Annual System Cash Flow Within Valuation Period:*

Each year Social Security faces an obligation to pay benefits, and it also generates revenue through its own dedicated tax. When the system has a positive annual cash flow, it has sufficient income to cover its costs that year. When the cash flow becomes negative, the system must redeem Trust Fund assets (or draw on interest on those assets) if available, or cut benefits, unless reform of some sort is enacted.

Positive annual cash flows are a useful metric of whether the program is self-financing. Other measures – such as solvency and actuarial balance – can be manipulated by governmental bookkeeping. They are also subject to continued argument over their meaning and utility. Positive annual cash flows are also easy to measure and to understand. The system is either taking in more money than it must spend, or it is not.

Social Security’s self-financing design is an important component of its policy basis and its political support. Self-financing helps to ensure fiscal discipline, by assuring that the program’s benefits and dedicated revenues remain aligned. Social Security’s separate accounting is also an important protection for the program, helping to ensure that all of its dedicated revenues are ultimately used to pay Social Security benefits.

The current system faces cash flow deficits that are anticipated to grow continually, exceeding 6 percent of the nation’s payroll by 2075. This is an annual shortfall in 2075 of \$1.36 trillion dollars (in constant 2001 dollars). The Commission believes that any reform proposal must, at a minimum, reduce the size of these cash flow deficits. The Commission also looks more favorably on plans that eliminate these deficits completely by the end of the 75-year valuation period.

Two key advantages to this measure are: 1) it is perhaps the most direct measure of the extent to which the program is self-financing in the long run; and 2) it is simple to explain to the public, since it does not rely on an understanding of the complexities of Trust Fund accounting. One disadvantage of this measure is that it does not indicate how the program is to be financed in the period before it reaches self-financing status.

Thus, this measure is not, by itself, sufficient to ensure the long-term sustainability of the system.

## *2. Improvement in System Solvency:*

The Office of the Actuary considers program “solvency” at any point in time in which the OASDI Trust Funds have a positive balance.<sup>35</sup> Under the Intermediate projections of the Social Security Trustees, the present system is projected to enter insolvency in the year 2038 and never regain solvent status. Solvency is important insofar as it affords the SSA the legal authority to make benefit payments. Without a positive Trust Fund balance, Social Security is authorized to pay benefits only from its dedicated tax revenue.

However, solvency is a narrow measure of the nation’s ability to pay Social Security benefits since it does not indicate the system’s long-run financial health nor does it consider the broader budgetary implications of paying for benefits.

As an illustration of the limitations of the solvency measure, solvency could be achieved in an accounting sense by issuing new bonds to the Trust Fund or raising the interest rate on existing Trust Fund bonds. However such an approach would not produce additional real resources needed to pay benefits. Thus solvency could be technically consistent with requiring future generations to make large general revenue transfers that they may not desire or be able to afford. In this sense, improving solvency is not sufficient to achieve long run fiscal sustainability.

## *3. Reduce Rate of Growth in Long-Term System Costs as a Percent of GDP:*

Social Security currently consumes 4.2 percent of the nation’s gross domestic product, or GDP. If additional revenues were to be devoted to Social Security to pay benefits under the scheduled benefit formula, that fraction would have to rise to 6.7 percent of GDP by the year 2075.

In the future, Medicare is also likely to command an increasing share of the nation’s resources, leaving less room in the budget to absorb Social Security’s rising costs. Combined, Social Security and Medicare are expected to absorb more than 15 percent of the nation’s output by the year 2075 unless these systems are made more sustainable. For comparison, all personal income taxes paid to the federal government today total approximately 9 percent of GDP.

An advantage to measuring a reform’s effect on the growth rate of system costs as a percent of GDP is that it recognizes that Social Security expenditures are a claim on the resources provided by taxpayers, in direct competition with other spending priorities. The limitation of this approach is that it does not consider system revenues, and thus represents only part of the equation. Therefore, while reducing the rate of growth in

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<sup>35</sup> In the context of the Trustees’ Report, the implied target also includes a contingency reserve of one year of Social Security outflows, or a Trust Fund ratio of 1.

system costs is compatible with long-run fiscal sustainability, it does not necessarily achieve it on its own.

#### *4. Improvements in 75-year Actuarial Balance:*

Social Security actuaries calculate the actuarial balance of the OASDI programs as the present value of Social Security system expected revenues minus present value of scheduled expenditures over the period in question. Social Security actuaries are required by Congress to make long-term calculations, and the Office of the Actuary has typically used a 75-year valuation period for this long-term analysis.

The current system is not in actuarial balance. The 75-year shortfall is equivalent, on average, to 1.86 percent of the nation's taxable payroll. This measure is a convenient shorthand for quantifying the magnitude of the financing shortfall, averaged over the valuation period.

However, this measure suffers from many important disadvantages. First, the measure is largely indifferent as to the timing of the cash outlays and cash receipts. As such, it treats a dollar of Social Security revenue the same whether that dollar was spent on Social Security benefits, saved, or spent on non-Social Security spending.

A second disadvantage is that this measure conceals trends in shortfalls. For example, the 1.86 percent actuarial deficit of the current system hides the fact that Social Security has surpluses today but will experience even larger shortfalls in 75 years -- exceeding 6 percent of taxable payroll.

A third disadvantage is that the 75-year time horizon is arbitrary since it ignores what happens to system finances in years outside the valuation period. For example, we could eliminate the actuarial deficit by immediately raising the payroll tax by 1.86 percent of payroll. However, as we move one year into the future, the valuation window is shifted by one year, and we will find ourselves in an actuarial deficit once more. This deficit would continue to worsen as we put our near term surplus years behind us and add large deficit years into the valuation window. This is sometimes called the "cliff effect" because the measure can hide the fact that in year 76, system finances immediately "fall off the cliff" into large and ongoing deficits.

A fourth disadvantage is that the criterion of actuarial balance is biased against programs that advance fund the system through personal accounts. This is because the value of the assets invested in personal accounts is not included as part of the calculation. Thus, many reforms that would *improve* the long-term financial footing of the system would appear to worsen it by this measure. In this sense, improvements in 75-year balance are useful but not the only measure that can be used to achieve fiscal sustainability.

#### *5. Gain in System Assets By the End of the Valuation Period:*

Current projections show that benefits specified under current law would leave Social Security underfunded by about \$3.157 trillion or about \$21,000 per current worker (in present value.) An important measure of the contribution of a Social Security reform proposal to the health of the Social Security system is the extent to which a given reform can reduce the size of this unfunded liability. This measure should include and quantify the assets held in personal accounts as well as by the Social Security Trust Fund.

*6. Reductions in general revenue requirements relative to current law:*

Under present law, the Social Security system would require substantial additional revenue to cover scheduled benefits. The extent to which these pressures are reduced is another important measure of the efficacy of a reform proposal.

*7. Actuarial Balance Not Deteriorating at the End of Valuation Period:*

The actuarial balance measure described under measure 4 can exhibit a “cliff effect,” in which system finances deteriorate rapidly in the year following the close of the valuation period. This is an outcome to be avoided. A way to address this problem would be to ensure that the actuarial balance is moving in the positive direction by the end of the valuation period.

One metric which can help assess this is the Trust Fund ratio, which measures the ratio of the OASDI Trust Fund balance relative to the benefits paid out in that year. A stable or rising Trust Fund ratio indicates that the actuarial balance is not deteriorating.

*8. Transition Investments*

Although transition investments are not in and of themselves a measure of fiscal sustainability, the total transition investment required under each alternative in Chapter 4 will be quantified as well. Transition investments are an issue that arises as a consequence of a move from a pay-as-you-go financing structure to one that includes partial advance funding. Chapter 4 defines the concept of transition investment, and explains how it is calculated with respect to each Reform Model.

*Finding: Transition investments in personal accounts are not “costs,” but investments in a fiscally sustainable Social Security system.*

The Commission strongly endorses the President’s principle that benefits for current retirees and persons nearing retirement should not be changed. This commitment to ensure full benefits to current and near-retirees raises the issue of so-called “transition costs.”

The current Social Security program is financed primarily on a “pay-as-you-go” basis, meaning that most of the payroll taxes paid by today’s workers are used to finance benefits for today’s beneficiaries. For the next 15 years, the program is expected to bring in more revenue than is required to pay benefits in each year.

Under a personal account program, workers would be given the option to invest a portion of their payroll taxes in accounts that they would own. Like any sound investment program, investing in personal accounts requires additional resources up front. During the transition to a personal accounts program, tax revenues invested in the accounts would no longer be available to finance traditional benefit payments, although during a period of program surpluses additional revenues exist to finance the accounts.

Therefore, funds must temporarily be found to finance personal account investment while simultaneously paying benefits to retirees. Over time, these investments in personal accounts offer financial returns to the Social Security program via reductions in the rate of growth of system costs, to retirees in the form of higher expected benefits, or both.

The temporary increase in resources needed to fund the investment in personal accounts is sometimes referred to as the “transition cost.” This terminology is often misunderstood, however, because it ignores the corresponding returns on these investments. To focus only on the “cost” of the investment while disregarding the benefits is to count only one side of the equation.

A simple analogy illustrates: Suppose an individual had a \$90,000 home mortgage with a monthly payment of \$600 over 30 years. By paying an extra \$100 monthly, the individual could pay off his mortgage in full within 20 years and thereafter have an “extra” \$600 per month to spend on other things. This additional \$100 monthly payment is an investment that brings rewards, not a cost.

Likewise, consider a business that retains profits in order to develop a new and lucrative technology. These retained profits could have been paid to shareholders, so retaining them for investment could be considered a “cost.” But this cost pays itself back in the future in the form of higher profits.

In short, if the extra saving proposed for Social Security personal accounts is considered a “cost,” then any person who saves or sacrifices for the future for any reason pays a similar cost. It is often said that Americans should “save and invest for

the future.” The so-called “transition costs” associated with personal accounts for Social Security are precisely that: saving and investing for the future, to reduce the need to raise taxes, cut benefits, or curtail other necessary government initiatives. The more Americans can save for the future, the better off we will be in the long run.

### *Measuring the Revenue Needed to Invest in the Transition*

Clearly, the resources needed to finance the movement to personal accounts cannot be viewed in isolation from the substantial benefits they bring. It is also important, however, to obtain an accurate measurement of the financing needs associated with a specific plan. In particular, it is essential to distinguish transition investments associated with personal accounts from the additional revenue required to address the fiscal problems already besetting the Social Security system. Solutions to fill the existing fiscal gap must be found regardless of whether personal accounts are established.

The current Social Security program faces long-term, growing deficits requiring either new revenue or a reduction in the rate of benefit growth. Opponents of reform often argue, incorrectly, that personal accounts *cause* the benefit changes or revenue increases required to fix the current system. This is simply and unequivocally false. Benefit or revenue changes are required *without* personal accounts, and over the long term these could well be larger in the absence of personal accounts than if such accounts are established. Funds needed to establish personal accounts represent “transition” funding only to the extent that costs might rise over and above the financing needed to keep the current program solvent.

In addition, Social Security’s traditional 75-year actuarial window artificially overstates the cost impact of personal accounts because it counts the “cost” of funding accounts within the 75-year period while ignoring benefits paid by those accounts outside of 75 years. Longer measurement periods or alternate accounting methods that measure both the costs and the benefits from personal accounts show that accounts strengthen Social Security rather than weakening it.

The short-term availability of Social Security surpluses will make transition financing even easier, if action is taken soon. For the past 20 years, Social Security surpluses have been used primarily to fund other government spending. If, instead, these surpluses are put into personal accounts, they are more likely to be used for their intended purpose of funding future Social Security benefits. According to Intermediate projections of the Social Security Trustees, Social Security is expected to run cash surpluses totaling \$811 billion in present value between now and 2016. The Commission believes that these resources should be used to fund the transition to personal accounts, rather than to finance other government spending programs.

*Finding: Personal accounts can reduce the long-term cost growth of the Social Security system, thus contributing to fiscal sustainability.*

All of the plans presented by the Commission provide individuals the option to invest in personal accounts. In all cases, these accounts are at least partially financed by a redirection of payroll tax revenue from the existing system. In return for the opportunity to pursue higher expected returns through personal accounts, individuals who choose the account agree to forgo the benefit that would have been financed by these payroll taxes (plus interest).

Therefore, every dollar invested in a personal account reduces the cost of future Social Security payments by one dollar, plus the offset rate of interest that is proposed for each plan (ranging from 2 percent to 3.5 percent after inflation). Total expected benefits to the worker are increased by the compounded difference between the offset rate of interest for the Reform Model and the expected rate of return earned by the personal account. So long as the personal account earns a return higher than the offset rate, both Social Security and the individual come out ahead.

*Finding: It is not necessary to change benefits for current or near-term retirees.*

The President has made a firm commitment that all current and near-retirees will not have their benefits changed. This commitment can and will be kept. The Commission has structured every proposal to be consistent with this charge. No proposal changes benefits in any way for any individual aged 55 or over.

The Commission finds that there are many feasible ways to restore Social Security to fiscal sustainability without touching the benefits of current or near-term retirees.

*Finding: Benefits can continue to grow at least as fast as inflation within current Social Security system tax levels.*

Restoring fiscal sustainability to Social Security does not require that we “cut” benefits below those paid to today’s retirees. In fact, every Commission Reform Model will increase benefits at least as fast as inflation, ensuring that no future generation of retirees receives less purchasing power than today’s retirees. Hence, fears that benefits will be cut or retirees thrown into poverty are simply false.

How is it possible to restore sustainability without cutting benefits or raising taxes? It is because the current benefit formula increases the starting benefit from year to year at the rate of wage growth, which is generally faster than is required to maintain purchasing power. This rate of benefit growth is not affordable given current system revenues. Fortunately, current payroll tax rates are sufficient to afford benefits that grow at least as fast as inflation.

Two of the three Reform Models presented in this report would peg the future rate of growth of benefits within the traditional Social Security system to a new rate that is sustainable within the revenues allotted to each program. None would reduce benefits below those paid to today’s retirees. All would pay higher benefits than those paid today, and in particular would target benefit increases for the low-income workers and widows who need them the most. Those who choose personal accounts would expect substantially higher benefits.

### **What is “Wage Indexation” of Benefits**

Under the current Social Security system, the initial benefits received by each cohort of new retirees rises at the rate of wage growth. (Following retirement, benefits rise annually to preserve purchasing power against inflation.) This wage indexation was not part of the original Social Security system. Until 1977, Congress had no formal policy of protecting beneficiaries from cost of living increases or replacing a certain percentage of pre-retirement earnings. Instead, Congress prevented the purchasing power of benefits from eroding via *ad hoc* adjustments in benefit levels, applied to persons currently on the rolls and to initial benefits for future retirees. In each of the more than dozen instances in which benefits were adjusted, the Congressional rationale was to preserve the purchasing power of benefits. In 1972, Congress replaced its policy of granting *ad hoc* increases with a policy that permanently indexed benefits to inflation.

An error in the 1972 law led to a major debate over indexing of benefits. All sides to the debate agreed that benefits following retirement years should be indexed to the cost of living. There was considerably less agreement about how initial benefits should be indexed over time. A special commission created by the Senate Finance and House Ways and Means committees rejected indexing initial benefits to wage growth, primarily

because it was unaffordable.<sup>36</sup> Instead, the commission recommended an alternative policy under which initial benefits would more closely track increases in prices than in wages. Commentators at the time argued that such a policy preserved the affordability of Social Security while granting Congress the ability to adjust benefits as needed in the context of the times.

Congress ignored the commission's warnings and in 1977 adopted the current policy of indexing initial benefits to wage growth. Since this policy's enactment, the Social Security Board of Trustees has issued 24 annual reports assessing Social Security's financial status. All but two of these reports, those issued in 1983 and 1984 following congressional enactment of the Greenspan Commission recommendations, have declared that without major tax increases the Social Security program is insolvent and will be unable to deliver its promised benefits.

As this historical record makes clear, wage-indexing of initial benefits coupled with existing demographic trends has never been fiscally sustainable.

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<sup>36</sup> The Commission noted that financing benefits under a wage indexed system would require an 80 percent increase in the payroll tax rate. (Report of the Consultant Panel on Social Security, August 1976, 94<sup>th</sup> Congress 2<sup>nd</sup> Session, page 6.)

## **Chapter 4: Alternative Paths to Fiscal Sustainability**

### *Summary of Findings*

*There are multiple paths to fiscal sustainability within the President's principles for Social Security reform.*

*The Reform Models presented in this chapter would contribute varying levels of progress to Social Security's long-term sustainability. Each has been transparently analyzed not only for its effects on Trust Fund operations, but on the unified federal budget as a whole.*

*Each of the actuarially solvent Reform Models (Models 2 and 3) presented would effect benefit increases for widows and for low-income workers, above current law, whether or not these individuals had participated in personal accounts.*

*Each of the Reform Models presented shows that, across the full spectrum of choices for balancing the traditional Social Security system, a personal account element would permit higher benefits to be paid than would be possible within equal revenue devoted to current system.*

*The Commission commends Congressional sponsors of actuarially sound reform proposals, and requests that any criticism of these and other proposals be accompanied by constructive alternatives.*

## ***Executive Summary***

### **Findings:**

The Commission agrees that personal accounts are fundamental to Social Security reform. While there are multiple paths to fiscal sustainability that are consistent with the President's principles for Social Security reform, we have chosen to include three reform models in the report that improve the fiscal sustainability of the current system, are costed honestly, and are preferable to the current Social Security system.

Under the current system, the benefits to future retirees are scheduled to grow significantly above the benefits received by today's retirees, even after adjusting for inflation. The cost of paying these benefits will significantly exceed the amount of payroll taxes collected. To bring the Social Security system to a path of fiscal sustainability — an essential task for any reform plan — there are differing approaches. The Commission believes that no matter which approach is taken, personal accounts can enhance benefits expected by future participants in the Social Security system.

### **Unifying Elements of the Three Reform Plans:**

- The Commission has developed three alternative models for Social Security reform that feature personal accounts as a central component. Under all three reform plans, future retirees can expect to receive benefits that are at least as high as those received by today's retirees, even after adjusting for inflation.
- All three models include a voluntary personal retirement account that would permit participants to build substantial wealth and receive higher expected benefits than those paid to today's retirees. Thus, all of the plans would enhance workers' control over their retirement benefits with accounts that they own and can use to produce retirement income, or pass on to others in the form of an inheritance.
- Because the Commissioners believe that the benefits currently paid to low-wage workers are too low, we have included a provision in two of the three plans that would enhance the existing Social Security system's progressivity by significantly increasing benefits for low-income workers above what the system currently pays. This provision will raise even more of our low-income elderly – most of whom are women – out of poverty. Two of the three models also boost survivor benefits for below-average income widows and widowers.
- The Commission has set a goal of moving the Social Security system toward a fiscally sustainable course that reduces pressure on the remainder of the federal budget and can respond to economic and demographic changes in the future. The three reform models outlined here are therefore transparently scored in terms of plan provisions, effects on workers' expected costs and benefits, and effects on Trust Fund operations as well as the unified federal

budget. We also identify clearly how large the personal account assets may be expected to grow as the system evolves.

- All three of the models improve the fiscal sustainability of the program, though some move farther than others. Model 1 would require additional revenues in perpetuity in order to pay scheduled Social Security benefits under the plan. Model 3 prescribes an amount of additional revenues needed to pay scheduled benefits under the plan, an amount that is smaller than that required under Model 1. Model 2 does not require permanent additional funding.
- All three models also require transitional investments to move to a system that includes Personal Accounts. These transitional investments advance fund future benefits, thus substantially reducing the cost on future generations.
- All three reduce the long-term need for general revenues as compared to the current, unsustainable, system. In two of the three plans (Models 2 and 3), the system's cash flow needs are met so that the benefits promised by each plan can be paid as retirees need them.
- All three of the models are expected to increase national saving, though some more than others.
- The Commission concludes that building substantial wealth in personal accounts can be and should be a viable component of strengthening Social Security. We commend our three models to the President, Members of Congress and to the American public in order to enrich national understanding of the opportunities for moving forward.

### *The President's Principles*

The President directed the Commission to propose Social Security reform plans that will strengthen Social Security and increase its fiscally sustainability, while meeting several principles:

- Modernization must not change Social Security benefits for retirees or near-retirees.
- The entire Social Security surplus must be dedicated to Social Security only.
- Social Security payroll taxes must not be increased.
- Government must not invest Social Security funds in the stock market.
- Modernization must preserve Social Security's disability and survivors components.
- Modernization must include individually controlled, voluntary personal retirement accounts, which will augment the Social Security safety net.

## *Understanding the “Benchmarks”*

In analyzing any plan for reforming Social Security, it is important to be clear about the benchmarks for comparison. Benchmarks could include:

- Benefits currently paid to retirees (“currently paid benefits”).
- Benefits payable in the future given projected tax revenues (“payable benefits”).
- Currently scheduled benefits from the existing system, which cannot be paid by existing payroll tax revenues (“scheduled benefits”).

Each of these benchmarks is significantly different. For example, workers and retirees have a reasonable understanding of benefits currently paid to retirees, so this is a concept we view as useful and understandable. It is more complex to explain “payable benefits” given that this requires forecasting future payroll taxes, and future retirement patterns. In general “payable benefits” would be expected to be higher than benefits currently paid to retirees, even after making necessary adjustments as a result of shortfalls arising in 2038 and thereafter. Finally, “scheduled benefits” refers to what the system might deliver if tax revenue were raised to keep the system solvent, which would require nearly a 50 percent payroll tax hike by 2075. In general, this report argues that “scheduled benefits” cannot be paid without adding substantially more revenue to the system. In this report, we find the most useful comparison is either to “currently paid” or to “payable benefits.”

## **Three Reform Models**

The three models for Social Security reform devised by the Commission demonstrate how alternative formulations for personal accounts can contribute to a strengthened Social Security system.

Reform Model 1 establishes a voluntary personal account option but does not specify other changes in Social Security’s benefit and revenue structure to achieve full long-term sustainability.

- Workers can voluntarily invest 2 percent of their taxable wages in a personal account.
- In exchange, traditional Social Security benefits are offset by the worker’s personal account contributions compounded at an interest rate of 3.5 percent above inflation.<sup>37</sup>
- No other changes are made to traditional Social Security.
- Expected benefits to workers rise while the annual cash deficit of Social Security falls by the end of the valuation period.
- Workers, retirees, and taxpayers continue to face uncertainty because a large financing gap remains requiring future benefit changes or substantial new revenues.

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<sup>37</sup> In practice, this would be computed as the Treasury Bond yield plus 50 basis points.

- Additional revenues are needed to keep the trust fund solvent starting in the 2030s.

Reform Model 2 enables future retirees to receive Social Security benefits that are at least as great as today's retirees, inflation adjusted, and, in addition, increases the Social Security benefits paid to low-income workers. Model 2 establishes a voluntary personal account, without raising taxes or requiring additional worker contributions. It achieves solvency and balances Social Security revenues and costs.

- Workers can voluntarily redirect 4 percent of their payroll taxes up to \$1000 (indexed annually to wage growth) to a personal account. No additional contribution from the worker would be required.
- In exchange, traditional Social Security benefits are offset by the worker's personal account contributions compounded at an interest rate of 2 percent above inflation.<sup>38</sup>
- Workers who opt for personal accounts can reasonably expect to receive a combined benefit greater than benefits paid to current retirees and also greater than the future benefits payable under the current system.
- The plan makes the system more progressive, by increasing the minimum benefit payable to 30-year minimum wage workers to 120 percent of the poverty line. Additional protections against poverty are provided for survivors as well.
- Benefits under the traditional component of Social Security would be price indexed, beginning in 2009.
- Expected benefits payable to a medium earner electing a retirement account would be 59 percent above benefits currently paid to today's retirees by 2052. At the end of the 75-year valuation period, the personal account system would hold \$2 trillion (in today's dollars), much of which would be new saving, an accomplishment that would not need increased taxes or increased worker contributions over the long term.
- Temporary transfers from general revenue would be needed to keep the Trust Fund solvent between 2025 and 2054.
- This model achieves a positive system cash flow at the end of the 75-year valuation period under all participation rates.

Reform Model 3 establishes a voluntary personal account option that generally enables workers to reach or exceed current-law scheduled benefits and wage replacement ratios. It achieves solvency by adding revenues and increasing benefits at a rate faster than inflation, but slower than wage growth..

- Personal accounts are created by a match of part of the payroll tax – 2.5 percent up to \$1000 annually – for any worker who contributes an additional 1 percent of wages subject to Social Security payroll taxes.

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<sup>38</sup> In practice, this would be computed as the Treasury Bond yield minus 100 basis points.

- The add-on is partially subsidized for workers in a progressive manner by a refundable tax credit.
- In exchange, traditional Social Security benefits are offset by the worker's personal account contributions compounded at an interest rate of 2.5 percent above inflation.<sup>39</sup>
- The plan makes the traditional Social Security system more progressive, by increasing the minimum benefit for a 30-year minimum wage workers to 100 percent of the poverty line (111 percent for a 40-year worker). The minimum benefit would be indexed to wage growth. Additional protections against poverty are provided for survivors as well.
- Benefits under the traditional component of Social Security would be adjusted by:
  - ◆ adjusting the growth rate in benefits for actual future changes in life expectancy,
  - ◆ increasing work incentives by decreasing the benefits for early retirement and increasing the benefits for late retirement, and
  - ◆ flattening out the benefit formula (reducing the third bend point factor from 15 to 10 percent).
- Benefits payable to workers who opt for personal accounts would be expected to exceed scheduled benefit levels and current replacement rates.
- New sources of dedicated revenue are added in the equivalent amount of 0.6 percent of payroll over the 75-year period, and continuing thereafter.
- Additional temporary transfers from general revenues would be needed to keep the Trust Fund solvent between 2034 and 2063.

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<sup>39</sup> In practice, this would be computed as the Treasury Bond yield minus 50 basis points.

## **Specifications of Commission Reform Models**

	<b><u>Model 1</u></b>	<b><u>Model 2</u></b>	<b><u>Model 3</u></b>
<b>PERSONAL ACCOUNTS</b>			
Personal Account Size	2%	4% up to \$1000 annually (indexed to wages each year)	1% new contribution plus 2.5% up to \$1000 annually (indexed to wages each year)
Voluntary	Yes	Yes	Yes
Additional Contributions Required?	This is a generic 2% plan that can be done with or without new contributions	None	1% of wages required to participate (subsidized through income tax system)
Real return that makes person better off with accts than without (SS defined benefit offset rate).	3.5%	2.0%	2.5%
Accounts owned by participants?	Yes	Yes	Yes
Accounts can be bequeathed to heirs?	Yes	Yes	Yes
Participants can choose from a mix of low-cost, diversified portfolios?	Yes	Yes	Yes
Contributions and account earnings splitting in case of divorce?	Yes	Yes	Yes
<b>TRADITIONAL SOCIAL SECURITY BENEFITS</b>			
New minimum benefit	None	By 2018, a 30-year minimum wage worker is guaranteed benefit equal to 120% of poverty level, inflation indexed.	By 2018, a 30-year minimum wage worker is guaranteed benefit equal to 100% of poverty level (111% for a 40-year worker), then rising with national wage growth.
Widow/Widower Benefits	No changes	Increased to 75% of couple benefits (vs.	Increased to 75% of couple benefits (vs.

		50% to 67% today) for lower wage couples	50% to 67% today) for lower wage couples
Changes to growth rate of traditional benefit for future retirees	None specified	Indexed to inflation instead of wages starting for those turning 62 in 2009.	Indexed to gains in average life expectancy (results in average annual growth of 0.5% over inflation)
Additional changes to traditional benefit formula	None specified	None specified	<p>3. Reduce benefit for early retirement and increase benefit for late retirement</p> <p>4. Gradually decrease bend point factor for highest income bend point from 15% to 10% starting in 2009</p>

<b>Reform Model 1: Increase in Total Benefits for Account Holders* Relative to Current Retirees</b>			
	Annual Benefit Levels (in 2001 dollars)		
Retirement Year	Low-wage worker	Medium-wage worker	High-Wage worker
2001	\$7,644	\$12,624	\$16,392
2032	\$10,140	\$16,944	\$22,620
Percent increase over current retiree	32%	34%	38%
2052	\$9,624**	\$16,476**	\$22,428**
Percent increase over current retiree	26%	31%	37%

\* Persons choosing 2 percent personal accounts.

\*\* Assumes the current system will pay benefits affordable under current law: \$8,568, \$14,148, and \$18,696, for low, average, and high earners respectively. Currently scheduled benefits are \$11,832, \$19,536 and \$25,812 respectively, but the system is projected to be 27.6% underfunded in 2052. Assuming that currently scheduled benefits are met, the total expected benefit with personal accounts would be: \$12,888, \$21,864 and \$29,544 respectively.

<b>Reform Model 2: Increase in Total Benefits for Account Holders* Relative to Current Retirees</b>			
	Annual Benefit Levels (in 2001 dollars)		
Retirement Year	Low-wage worker	Medium-wage worker	High-Wage worker
2001	\$7,644	\$12,624	\$16,392
2032	\$11,160	\$15,444	\$19,680
Percent increase over current retiree	46%	18%	17%
2052	\$13,608**	\$20,016**	\$24,684**
Percent increase over current retiree	78%	59%	51%

\*\* Assumes the current system will pay benefits affordable under current law: \$8,568, \$14,148, and \$18,696, for low, average, and high earners respectively. Currently scheduled benefits are \$11,832, \$19,536 and \$25,812 respectively, but the system is projected to be 27.6% underfunded in 2052.

<b>Reform Model 3: Increase in Total Benefits for Account Holders* Relative to Current Retirees</b>			
	<u>Annual Benefit Levels (in 2001 dollars)</u>		
Retirement Year	Low-wage worker	Medium-wage worker	High-Wage worker
2001	\$7,644	\$12,624	\$16,392
2032	\$10,932	\$17,412	\$22,620
Percent increase over current retiree	43%	38%	38%
2052	\$14,112**	\$23,796**	\$31,668**
Percent increase over current retiree	85%	88%	93%
** Assumes the current system will pay benefits affordable under current law: \$8,568, \$14,148, and \$18,696, for low, average, and high earners respectively. Currently scheduled benefits are \$11,832, \$19,536 and \$25,812 respectively, but the system is projected to be 27.6% underfunded in 2052.			

## ***Fiscal Sustainability Results***

In accordance with the Executive Order establishing this Commission, the report uses a number of criteria to assess improvements to the Social Security system's fiscal sustainability. Results are outlined in the text, and summarized in the table following this summary. As a rule, reform models that include Personal Accounts require some investment during an initial period, with greater expected benefits in the medium and long term. The Commission Report therefore evaluates both transition investments and the status of system assets after the implementation of the various reform models. In addition, several other fiscal sustainability criteria are provided.

### ***Expected Personal Account Assets and Gain in System Assets by End of Valuation Period***

Current projections show that benefits specified under current law would leave Social Security underfunded by about \$3.157 trillion or about \$21,000 per current workers (in present value). An important measure of the contribution of a Social Security reform proposal to the health of the economy is the extent to which a given reform can reduce the size of this unfunded obligation. We emphasize this measure as it quantifies the contribution of personal accounts plans to our nation's long-term economic well-being,

Each of the models developed here improves this situation, to some degree. Line 1 of the table shows that in today's dollars, Model 1 would be projected to have Personal Account assets of \$10.3 trillion in 2075 (\$1.1 trillion in present value); Model 2 would have \$12.3 trillion (\$1.3 trillion present value), and Model 3 would have \$15.3 trillion (\$1.6 trillion present value). The overall gain in system assets, inclusive of Trust Fund balances, is reported in Line 2. Here we see that each model improves on the current system's projected debt in present value terms, in Model 1 by \$0.5 trillion, in Model 2 by \$4.8 trillion, and in Model 3 by \$5.0 trillion.

### ***Reductions in General Revenue Requirements Relative to Present Law***

Each year Social Security faces an obligation to pay benefits, and it also generates revenue through its own dedicated payroll tax as well as taxation of benefits and interest on Trust Fund assets. Under present law, the system would require substantial additional revenue to cover scheduled benefits. Each of the Commission's proposed models improves fiscal sustainability by ultimately requiring less additional revenues to cover benefits. Line 3 of the table indicates that Model 2 would effect the largest reductions relative to current law. Specifically, additional revenue requirements over the next 75 years are 45 percent lower for Model 2, and 34 percent lower for Model 3 (in present value terms). Model 1 would create a 4 percent increase in present value terms, but an 8 percent improvement in real dollars. (The difference is due to the fact that Model 1's improvements over current law are late in the valuation period, and are thus discounted the most using a present-value calculation.)

## ***Social Security Cashflow Patterns Relative to Present Law***

In years when the Social Security system has a positive annual cash flow, it has sufficient income to cover its costs. Positive annual cash flows are a useful metric of whether the program is self-financing and the measure is also easy to understand. Social Security's separate accounting is also an important protection for the program, helping to ensure that all of its dedicated revenues are ultimately used to pay Social Security benefits without additional general revenue. The current system faces cash flow deficits beginning in 2016 that will grow continually, exceeding 6 percent of the program's taxable payroll by 2075. This is an annual shortfall in 2075 of \$673 billion in constant 2001 dollars.

The three models described in this Report reduce the size of anticipated cash flow deficits by the end of the 75-year valuation period, as illustrated in Line 4 of the table. Model 1 does not eliminate the cashflow shortfall without additional general revenue by 2075. This is also the case for Model 3, but with the addition of new permanent revenue discussed in the text, cashflow would turn positive by that year. Model 2 has a positive cashflow of 1.41 percent of payroll within the valuation window, without the need for permanent revenue increases.

## ***Improvement in Actuarial Balance Over 75-Year Period***

Social Security actuaries calculate the actuarial balance of the OASDI program as the present value of Social Security system expected revenues minus the present value of scheduled expenditures over the period in question. Social Security actuaries are required by Congress to make long-term calculations, and the Office of the Actuary has typically used a 75-year valuation period for this long-term analysis. By this standard, the current system is not in actuarial balance with a 75-year shortfall equivalent to 1.86 percent of taxable payroll on average.

Line 5 of the table reports improvements in the system's actuarial balance though 2075 under each of the models, with and without additional sources of long-term revenue. Actuarial balance is achieved by Model 2 but only after the temporary addition of general revenue between 2025 and 2054. Achieving actuarial balance under Model 3 requires the addition of both temporary and permanent sources of revenue as specified in the text. Model 1 does not achieve balance.

## ***Transition investment and Long-Term System Costs as a Percent of GDP***

Social Security currently consumes 4.2 percent of the nation's gross domestic product, or GDP. If additional revenues were to be devoted to Social Security to pay benefits under scheduled benefit formulas, this fraction must rise to 6.7 percent of GDP by the year 2075. In the text of the Report, we show how each reform influences the growth rate of system costs as a percent of GDP. Thus we recognize that Social Security expenditures are a claim on real economic resources provided by taxpayers, in direct competition with other spending priorities.

The three models developed by the Commission require varying degrees of investment to move the system toward sustainability. Improving Social Security's finances for the long run involves an investment over a shorter period, followed by a longer period during which the system reaps returns. There is no well-defined way to measure the transition investment, so we offer the measures displayed in the table. Each of these answers the question, "How large is the investment required from the Unified Budget to finance a move from the current unsustainable system to the proposed model that includes personal accounts?" This is reflected in difference between the additional budgetary resources needed to insure that all benefits are paid over the investment period. The first panel under Line 6 computes the present value of these resources, assuming that current social security surpluses would not be available for financing; the second panel includes such surpluses. In both cases we also report the figures as a percent of Gross Domestic Product over the years included in the calculations.

A further discussion of transition investment is provided in the Methodology section of this chapter.

Assuming surpluses would not be available for transition financing, Model 1's transition cost is \$1.1 trillion, Model 2's is \$0.9 trillion, and Model 3's is \$0.4 trillion. If current surpluses were available, the costs would decline to \$0.7 trillion for Model 1, \$0.4 trillion for Model 2, and \$0.1 trillion for Model 3. As a percentage of GDP, the latter values are remarkably small, at 0.29 percent, 0.33 percent, and 0.10 percent respectively.

<b>Summary Results: Fiscal Sustainability Assuming 2/3 Participation in Personal Accounts (PA)</b>	<b>Model 1</b> <sup>1/</sup>	<b>Model 2</b>	<b>Model 3</b>	<b>Current Law</b>
<b>1. Expected PA assets at end of 2075 (\$PV trillions)</b>	\$1.1	\$1.3	\$1.6	NA
<b>2. Gain in Social Security "system" assets at end of 2075 (Increase in Trust Fund + Expected PA Assets; \$PV trillions)</b>	\$0.5	\$4.8	\$5.0	NA
<b>3. Reduction in cash flow requirements from general revenue relative to present law</b> <sup>2/3/</sup>				
Reduction in 75-year total (Sum of Ann Amts in \$2001 trillions) <i>Percent reduction versus current law (in \$2001)</i>	\$1.7 7.7%	\$14.8 68.1%	\$11.3 52.2%	\$0.0 0.0%
Reduction in 75-year total (\$PV trillions) <i>Percent reduction versus current law (in PV)</i>	-\$0.2 -3.8%	\$2.3 45.0%	\$1.7 33.9%	\$0.0 0.0%
<b>4. Social Security Cashflow</b>				
<b>With dedicated general revenue</b>				
Positive by end of valuation window?	No	Yes	Yes <sup>4/</sup>	No
Income Rate (incl. GR Transfer)-Cost Rate in 2075 (% of payroll)	-4.56	1.41	0.12 <sup>4/</sup>	-6.05
<b>Without dedicated general revenue</b> <sup>3/</sup>				
Positive by end of valuation window?	No	Yes	No	No
Income Rate (excl. GR Transfer)-Cost Rate in 2075 (% of payroll)	-4.56	1.41	-0.75	-6.05
<b>5. Improvement in Actuarial Balance over 75-year period</b>				
Improvement with general revenue transfer (% of payroll) <i>Percent improvement with general revenue transfer</i>	-0.32 -17%	1.99 107%	1.88 101%	0
Improvement without general revenue transfer (% of payroll) <sup>3/</sup> <i>Percent improvement without general revenue transfer</i>	-0.32 -17%	1.15 62%	0.87 <sup>5/</sup> 47%	0
<b>6. Transition investment</b>				
<b>Assuming current law surplus not used for financing</b> <sup>6/</sup>				
\$ PV trillions	\$1.1	\$0.9	\$0.4	
<i>As % of GDP over years included in calculation</i>	0.36%	0.49%	0.25%	
<b>Includes current law surplus available for financing</b> <sup>7/</sup>				
\$ PV trillions	\$0.7	\$0.4	\$0.1	NA
<i>As % of GDP over years included in calculation</i>	0.29%	0.33%	0.10%	NA
<b>Notes:</b>				
1/ Model 1 does not include additional transfers for balance.				
2/ Cash flow requirements are defined as general revenue required in any year to maintain solvency in the absence of dedicated revenues.				
3/ Taxes on benefits and on PRA distributions are treated as Social Security revenues, not general revenue.				
4/ Includes new dedicated sources of revenue; see text.				
5/ Improvement in actuarial balance would be +1.50 if new dedicated sources of revenue are included; see text.				
6/ Unified budget concept: Diff between income and cost of proposed model versus present law				
7/ Reflects extent to which negative balance in any year is more negative than under current law.				

## **Personal Accounts and Social Security Reform**

*Finding:* The Commission concludes that there are multiple paths to fiscal sustainability that are in keeping with the President's principles for Social Security reform.

The Commission has developed three reform models compatible with the President's principles that also move Social Security toward fiscal sustainability. All three models include a personal account element that would permit participants to build substantial wealth, diversify their retirement portfolios, and receive higher expected benefits than those paid to today's retirees. All three models improve fiscal sustainability, though some move farther than others. All three require an investment to strengthen Social Security, but all three reduce the long-term need for general revenue as compared to the current, unsustainable, system. Two of the three models enhance Social Security's progressivity by increasing benefits for low-income workers above what the system currently pays. Two of the three models also boost survivor benefits for poor widows and widowers. All of the plans would enhance workers' control over real retirement accounts that they own and can pass on as an inheritance. These features will benefit women and minorities, as well as all low-income workers. In all three plans, the system's cash flow needs are met so as to ensure that promised benefits can be paid as retirees need them.

The Commission set a goal of moving the Social Security system toward a fiscally sustainable course that reduces pressure on the remainder of the federal budget and can withstand economic and demographic changes in the future. The three reform models outlined here are therefore transparently scored in terms of plan provisions, effects on workers' expected costs and benefits, and effects on Trust Fund operations as well as the unified federal budget. We also identify clearly how large the personal account balances may be expected to grow as the system evolves.

The Commission concludes that building substantial wealth in personal accounts can be and should be a viable component of strengthening Social Security. We commend our three models to the American public in order to enrich national understanding of the opportunities for moving forward.

### *Process*

The Commission is a bipartisan group, and each member brought to the task an understanding of the Social Security program and an expressed willingness to seek bipartisan recommendations that meet the President's charge. All of the Commission's work has complied with regulations regarding the group's deliberations and meetings. The Commission has worked together 7 months, held 8 public meetings, heard testimony from 34 people, met with numerous members of Congress and the public, and worked with experts from the Social Security Administration.

## **Methodology**

### *Rate of Return/Portfolio Assumptions*

The Commission believes it is important to use a consistent set of conservative assumptions to evaluate plans. To this end, all three plans scored in this report utilize a common set of assumptions about personal account portfolios, rates of return, and administrative costs.

For the main results presented herein, an individual investing in personal accounts is assumed to hold a portfolio consisting of 50 percent equities, 30 percent corporate bonds, and 20 percent government bonds. Individuals are assumed to annually rebalance their portfolios to maintain these portfolio shares throughout life.

In the pre-retirement period, a portfolio of 50 percent stocks and 50 percent bonds may be considered quite conservative, particularly for younger workers. Analysis by the non-partisan Employee Benefits Research Institute indicates that in 1999, the average 401(k) retirement plan portfolio allocation was over 70 percent in equities. For workers under the age of 40, over 80 percent of assets were held in equities.

Other more recent sources of data indicate a similar propensity for investors to hold a portfolio that is more heavily weighted towards equities. In June 2001, participants in TIAA-CREF, a leading retirement plan for college professors and researchers, held an average of 58 percent of their portfolios in equity, suggesting that even in the face of a year-long market downturn in equities participants chose to hold the majority of their portfolio in equities. A similar story is told by the federal Thrift Savings Plan, in which 62 percent of plan assets were held in equities in the first half of 2001.

The Commission's projections use the rates of return on these assets recommended by the Office of the Actuary of the Social Security Administration. Equities are assumed to provide an ultimate expected real rate of return of 6.5 percent.<sup>40</sup> Corporate and Treasury bonds are assumed to provide a real rate of return of 3.5 percent and 3.0 percent respectively. Administrative costs are assumed to equal 30 basis points (0.3 percent of the account balance). If the accounts were to be structured according to a Thrift Savings Plan model, actual expenses would likely be lower than this. The overall expected real return for this 50-50 portfolio, net of expenses, is therefore a conservative 4.6 percent.

This portfolio return is much lower than that used in many academic and policy studies of personal accounts. For perspective, the historical real rate of return on US equities averaged 7.75 percent between 1926-2000. Using a higher portfolio return would obviously increase benefits to a level higher than those reported here.

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<sup>40</sup> By "real return" is meant return in excess of the rate of inflation.

In the primary results presented here, the individual is assumed to convert to a variable annuity upon retirement that is invested in the same underlying portfolio as during the accumulation phase. The variable annuity is priced using an “assumed interest rate” of 4.6 percent after inflation. Therefore, if the underlying investment portfolio provided an actual rate of return that was equal to its expected return, the variable annuity’s value would increase in line with the expected rate of inflation. In those periods when the portfolio beats its expectation, benefits will increase faster than inflation. In those periods when the portfolio return falls short of its expectation, the real value of benefits would decline. As with the accumulation phase, the decision to invest in variable annuities involves a trade-off between the higher expected rates of return and the higher volatility of equities.

Because the current Social Security system pays benefits entirely as an inflation-indexed annuity, some analysts have suggested that personal account balances should be converted to inflation-indexed annuities in the retirement phase. Results for inflation-indexed annuities are presented in the data appendix.

However, it is reasonable to assume that some equity exposure in the retirement phase may in fact be optimal for most retirees. In every plan presented in this report, the personal account annuity supplements an inflation-indexed annuity that is provided by the traditional defined benefit portion of Social Security. This defined benefit portion of retirement income should be considered part of the overall retirement portfolio. Therefore, while equities may make up 50 percent of the variable annuity portfolio, they comprise a far smaller share of the overall Social Security retirement income portfolio.

As a stylized example, consider a situation in which the traditional defined benefit from Social Security is expected to account for 60 percent of total retirement income, and the variable annuity is expected to account for the other 40 percent. Then the individual’s overall retirement income portfolio is essentially invested in 60 percent inflation-indexed securities, 20 percent corporate and government bonds, and only 20 percent equities. In this example, the variable annuity portfolio assumption would be equivalent to assuming an 80 percent bond, 20 percent equity portfolio.

### *How the Account Offset Functions*

For workers who choose personal accounts, benefits from the traditional system are offset at a given interest rate (3.5 percent in reform model 1; 2 percent in option 2; and 2.5 percent in option three). These offset rates are tied to the government bond return, projected to be 3 percent annually after inflation; if the bond rate moves, the offset interest rate will move along with it.

The offset functions in the following way: contributions to the account are compounded at the stated offset interest rate, producing a notional total at retirement. This notional total is converted to a monthly annuity payment, which offsets the individual's traditional Social Security benefit. As long as the personal account earns a higher average rate of return than the offset rate, benefits derived from the account will exceed benefits offset from the traditional system and the individual's total income will increase. Under this formulation, the individual need not master the complexities of Social Security's benefit calculation. He knows that he is getting more benefits than he is giving up if his personal account return exceeds the offset interest rate. In two of the three plans, a worker could guarantee himself higher total benefits simply by investing in government bonds.

Offsets under the plans are not taken from the personal accounts, and do not in any way depend on the assets in the accounts when the individual retires. The offsets are a function of the initial contributions to the accounts and represent a voluntary choice to invest those contributions in personal account benefits instead of "buying" benefits from the traditional Social Security system. None of the models reviewed by the Commission involve such reductions in Social Security benefits at the point of retirement. Individuals would retain ownership over 100 percent of the proceeds in their personal accounts, and no adjustments to traditional Social Security benefits would be made as a function of the accumulations in the accounts. The adjustment depends only on contributions to the account and the offset interest rate charged on these contributions.

### *Why Not Construct the Offset Simply as a Flat Percentage of Benefits? Constructing a Simple Personal Account Election*

Under some proposals, participants electing personal accounts would have the opportunity to invest a flat percentage of their earnings in a personal account in exchange for a flat percentage reduction in their traditional Social Security benefits. The Commission found three reasons why such proposals might be problematic under our criteria.

First, the traditional Social Security benefit formula is progressive. Accordingly, benefits for low-income workers represent a higher percentage of their lifetime earnings than for high-income individuals. For this reason, a flat offset formulation would mean larger relative reductions in traditional benefit for low-income workers, thereby reducing the program's overall progressivity.

The Commission's Interim Report identified several ways in which Social Security's apparent progressivity is reduced by factors such as differences in life expectancies between upper and lower-income workers. Further reducing system progressivity would exacerbate these difficulties.

The Commission stresses that these concerns do not mean that flat percentage offsets should be ruled out as a policy option. We note, however, that such a design would likely require additional policy changes in order to reach distributional goals.

A second reason is the fact that a contribution to a personal account would produce more in benefits if that contribution has a longer period of time in which to compound. Accordingly, a contribution at age 50 should not produce the same percentage offset as an equal contribution at age 25, which a flat percentage offset would do.

A third reason is simplicity. Workers do not know in advance what their Social Security benefits will be, but they should have a readily-understood standard by which to choose whether to opt for a personal account.

### *Participation Rates in Personal Accounts*

Construction of a voluntary personal account option raises the analytical question of what participation rates to assume. Traditionally, the Social Security Office of the Actuary produces alternative projections that show the effects of both 0 percent and 100 percent participation in the accounts.

In practice, however, participation will be somewhere between these extreme bounds of 0 percent and 100 percent. For that reason, the Commission has settled on an illustrative participation rate of 67 percent, though projections for 100 percent participation are included in the data appendix.

In reality, each of these Reform Models would likely inspire different participation rates. Reform Model 1, for example, would exact a steeper benefit offset in exchange for personal account benefits than would either Model 2 or 3. Model 3, unlike Models 1 and 2, would require additional out-of-pocket contributions to the account. These factors, among other design features, would influence participation rates. Participation rates for Model 2 would likely be highest because no additional out-of-pocket contributions would be required, and the offset rate would be the lowest for the three plans.

### *Values in Dollars: Current, Constant, and Present-Value*

Over a 75-year time horizon, the value of a dollar varies considerably, in inflation-adjusted terms, and in present-value terms. There is no one “correct” way to portray dollar figures, and the Office of the Social Security Actuary makes use of each of current dollars, constant (inflation-adjusted) dollars, and present-value analyses.

For the most part, the Commission report avoids use of current dollars, which neglect the effects of inflation. Real (constant 2001 inflation-adjusted) dollars will be used in most instances when reference is made to an annual amount. When measuring amounts that must be summed over a long-term time horizon, such as 75 years, the Commission report will use present values, discounted at the Treasury yield rate.<sup>41</sup>

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<sup>41</sup> There are exceptions to these conventions in the report, which reflect the limitations on data available at the time the report was released.

*Charts: Financial Operations of the Social Security System*

Each Reform Model will be analyzed according to its projected effects on the finances of the Social Security system as a whole, as well as its effect on beneficiaries.

For each Model, annual cost and income rates will be shown for each year as a percentage of Social Security's annual taxable payroll.

## *Measuring Transition Financing Under the Three Reform Models*

During the drafting of this report, it has become clear that there is a pressing need for a clear and concise summary measure of the transition investment associated with each Reform Model developed by the Commission.

The Summary Table included in the Executive Summary shows a simple “bottom line” figure for the transition investment under each Reform Model. Further details are included in the separate discussions of each Model.

The figures in the Executive Summary are taken from the projections of the Office of the Social Security Actuary. In every year where financing needs are greater under the Reform Model than they would be under current law, that year is identified as a “transition year.” All required extra financing is added up for each transition year, and the sum is given on the table.

These numbers show only one side of the equation: by contrast, the benefits of advance funding, manifested in reduced costs when the transition is over, are not included.

Transition investments are shown two ways. The total transition investment is shown, as well as the transition investment above and beyond what is already accounted for by projected Social Security surpluses under each model. It can be fairly presumed that Social Security surpluses under each model would be used to fund transition investments and that the only “net” new required transition investment would be that beyond what is already available from such cash surpluses.

As indicated earlier, the resources needed to finance a transition to personal accounts cannot be viewed in isolation from the benefits created by personal accounts. Saving and investing for the future requires that some consumption be forgone in the short term in order to meet obligations in the long term. Each of the three reform models presented would result in a different period of time before new saving and investment would pay off in reduced costs.

It is extremely important that different “transition” terms not be confused. Some frameworks would involve a “transition loan” to the Social Security Trust Fund to preserve its solvency until a period of permanent surpluses is reached -- a loan that would not begin for more than two decades from now. This is different from what many observers mean when they refer to a plan’s “transition” effects. For example, some refer to the “transition” effects of creating personal accounts over the next ten years, even though no “transition loans” would be required during that period in order to ensure solvency. By this definition, the “transition” is simply the period in which the new system’s cash requirements are greater than the current system’s. It is this latter definition that shall be referred to in these sections concerning “transition” financing.

*Relationship to the Lockbox: For purposes of clarity, the Commission notes that the Social Security “lockbox,” as it was intended to operate before recent national security*

*developments, was intended to wall off both Social Security cash and interest surpluses. The figures above reference cash surpluses alone. If both cash and interest surpluses were protected in the future, then transition financing needs would be postponed considerably beyond the years indicated above.*

## Impact on the Unified Federal Budget

Each proposal will have different effects on the unified federal budget as a whole. Under current projections, spending on Social Security would grow at an unsustainable pace that would crowd out many other forms of government spending. It is therefore important that any reform proposal have a positive long-term effect on the federal government's ability to produce the resources necessary to fund Social Security benefits within the federal budget.

Each of these models would have different effects on the federal budget over time. For all three of the models, the move towards personal accounts would have short-term transition challenges to be followed by long-term gains. For two of the models, changes to bring balance to the pay-as-you-go Social Security system would themselves have positive effects on the federal budget throughout the valuation period. The interaction between these elements produces each proposal's unique effects on federal budget projections.

The Office of the Social Security Actuary has produced estimates of the net impact of each proposal on the unified federal cash budget, which are presented in the accompanying discussions.

### *The Role of Congressional Proposals in the Commission's Analysis and Reporting*

Many members of Congress have offered plans to sustain Social Security with personal accounts, and the Commission has studied and evaluated these in substantial detail. Commission members have particularly appreciated the work of Congressmen Jim Kolbe (R-AZ), Charles Stenholm (D-TX), Nick Smith (R-MI), Jim DeMint (R-SC) and Richard Armey (R-TX) in presenting constructive proposals for the Commission's consideration. The Commission applauds the effort that many Members of Congress have demonstrated by working diligently to develop comprehensive, actuarially-scored proposals.

Congressional sponsors of proposals as well as other sponsors of serious comprehensive reform proposals are entitled to have their plans understood and discussed. This entails that plans be compared to the proper baseline of an imbalanced Social Security program in which benefits would be precipitously reduced or taxes precipitously raised when the Trust Fund became insolvent.

They are properly compared not to an unrealistic baseline in which all promised benefits materialize without collection of the necessary tax revenue, but to two actual alternatives: 1) a Social Security system that will become insolvent, or 2) a system in which tax revenues are increased to sustain the scheduled benefit level. We urge that, for credibility, critics of our reform plans or those of others should be expected to offer comprehensive reform alternatives of their own.

## ***How the Commission's Reform Models Improve Social Security's Treatment of Women***

While Reform Model 1 retains the current system's protections for women by making no changes to current benefit schedules, Reform Models 2 and 3 would make targeted improvements in the treatment of women.

Both models institute new protections against poverty for low-income workers, among whom women are disproportionately represented. By 2018, Reform Model 2 would guarantee that an individual who worked for at least 30 years at the minimum wage would retire with an income at least 120 percent of the poverty line. Reform Model 3 would guarantee that such a worker retired with an income at least 100 percent of the poverty line (111 percent for a 40-year worker). These are new protections against poverty in old age that do not exist in the current program.

Reform Models 2 and 3 would also increase benefits for widows, who suffer among the highest poverty rates in retirement. Currently, a widow's benefits are reduced by between one-third and one half relative to the total benefits she and her spouse received. Under these new protections, widows of below-average wage earners would receive 75 percent of their total couple's benefit, thereby reducing poverty for this vulnerable population.

Finally, under the current system a woman who is divorced prior to ten years of marriage receives no credit toward benefits based on her husband's earnings. As the average divorce takes place prior to the tenth year of marriage, this deprives many women of benefits they would otherwise have received. All three Reform Models go some way toward addressing this problem by dictating that personal account assets accumulated during marriage, as well as all earnings on account assets brought into marriage, would be split equally between husband and wife in the event of divorce. This would ensure that divorced women would not leave a marriage without any assets or wealth.

## ***Reform Model 1: Voluntary Personal Account and Offset, Combined with No Change to Traditional Social Security System***

### **The Model:**

Reform Model 1 establishes a voluntary personal account by permitting workers to invest a specified amount such as 2 percent of their taxable wages in a personal account. In exchange for the benefits generated by the personal account, traditional Social Security benefits would be offset by the amount of personal account contributions, compounded at a real interest rate of 3.5 percent.

Reform Model 1 would permit policymakers to separate the issues of permanent fiscal sustainability and personal accounts. Specifically, it would provide policymakers with an opportunity to establish personal accounts in a manner that simultaneously makes a modest contribution to long-term sustainability, and also offers improved treatment of beneficiaries.

This option would be relevant if Congress decided to act on creating personal accounts with or without also acting to restore fiscal sustainability. In the particular example scored here, individuals would be given the opportunity to invest 2 percent of their taxable wages in a personal account. This framework, however, could be adapted to allow for accounts that are of different size or construction. The accounts could be made larger, or smaller. They could be funded in a progressive fashion (with a higher contribution rate based on the first dollars of earnings than on higher earnings amounts). Some have proposed that such accounts be supplemented with extra contributions for younger workers or that such accounts be funded from general revenues. (One approach to this would be the idea proposed by former Senators Moynihan and Kerrey, which they denoted “Kidsave.”) Others have suggested that the accounts be made larger, with the requirement that a certain amount be invested in federal securities as a means of limiting the total size of the transition investment. Though the plan scored here envisions a 2 percent account for all wage earners, any of the above variations could be fit within this framework.

Another variation on this general framework would be to supplement traditional Social Security benefits with voluntary personal accounts, established and financed by the mechanism described by the co-chairs in their introduction to this report. Under this option, workers would be given the opportunity to invest an additional one percent of their pay in a personal account, and to receive a one percent match from general revenues. Such accounts may or may not interact directly with the Social Security system, depending on the design of the personal account. Structured purely as a supplementary “add-on” account, the accounts would produce additional income for participants, without affecting the underlying finances of Social Security. It would also be possible to design such accounts to play a role in funding a portion of existing Social Security benefit promises, and thereby to use the accounts to help shore up the finances of traditional Social Security.

## ***Key Elements of Model 1:***

### **Personal Accounts**

Workers would be given the opportunity to invest 2 percentage points of their taxable wages in a personal account. In exchange for this, traditional Social Security benefits would be offset by the amount of personal account contributions, compounded at a real interest rate of 3.5 percent. So long as the yield on the personal accounts exceeded this 3.5 percent real rate, workers would anticipate receiving higher total retirement benefits by electing the personal account.

### **Projected Benefits**

Traditional Social Security benefits would be offset by the amount of personal account contributions, compounded at a real interest rate of 3.5 percent.

Model 1 is a flexible framework. It can be molded to fit the particular desires of policymakers with respect to such factors as the size of the accounts, whether to establish a progressive funding mechanism for the accounts, and whether to act simultaneously to ensure fiscal sustainability.

The Commission projections suggest that individuals opting for personal accounts can expect higher benefits under Model 1 than payable under the current system. The program's fiscal challenges would remain qualitatively similar to current law.

Under Model 1, further actions would be required by Congress in order to ensure a fiscally sustainable system. Accordingly, projections of total benefits are less certain than would be the case under Models 2 and 3. If future action to restore sustainability to Social Security affects the growth of benefit levels in the traditional system, this would affect participants in personal accounts with respect to their benefits provided from the traditional system.

Under current law, additional revenue would be required in order to sustain full scheduled benefits, or else benefits would be suddenly reduced by 27 percent in 2038. Accordingly, benefits for those who opt for personal accounts under Model 1, as well as for those who do not, are shown on the accompanying charts with recognition of this uncertainty: after 2038, two lines are shown – the level of current benefit promises, as well as the level of benefits that would actually be paid under current law.

When fully phased in, expected benefits for a medium earner would be approximately 12 percent higher for individuals who opt to participate in accounts relative to benefits scheduled under the current system. In comparison to a scenario in which the current system delivers only those benefits payable under current law, the expected gain from the personal account option would be 16 percent. By 2075, \$1.1 trillion in assets (present value) are projected to have been accumulated in the personal accounts under

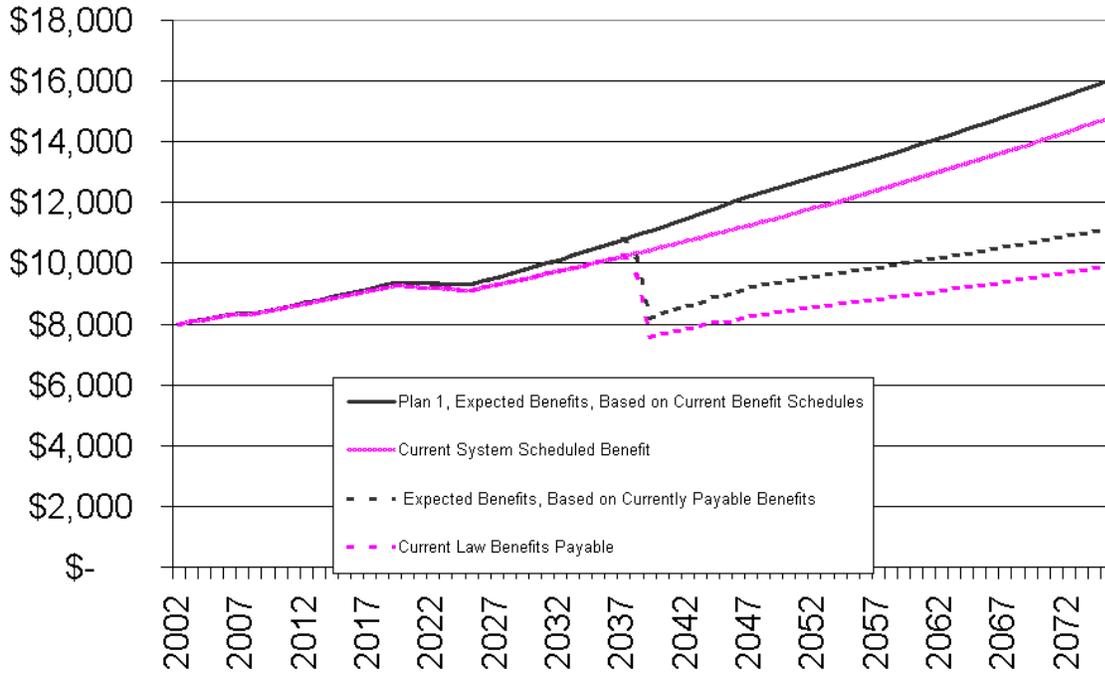
the operating assumption of two-thirds participation. A fuller explanation of benefit projections is provided below.

<b>Plan 1: Two percent personal account, no changes to underlying system</b>						
				<b>Reform Model Benefits</b>		
<b>Year</b>	<b>Relative Earnings</b>	<b>Today's benefit levels</b>	<b>Current Law benefit</b>	<b>Expected benefit with account</b>	<b>Increase relative to today's benefit</b>	<b>Additional increase due to account</b>
2032	Low	\$7,644	\$9,756	\$10,140	\$2,496	\$384
	Medium	\$12,624	\$16,116	\$16,944	\$4,320	\$828
	High	\$16,392	\$21,288	\$22,620	\$6,228	\$1,332
2052	Low	\$7,644	\$8,568*	\$9,624*	\$1,980	\$1,056
	Medium	\$12,624	\$14,148*	\$16,476*	\$3,852	\$2,328
	High	\$16,392	\$18,696*	\$22,428*	\$6,036	\$3,732

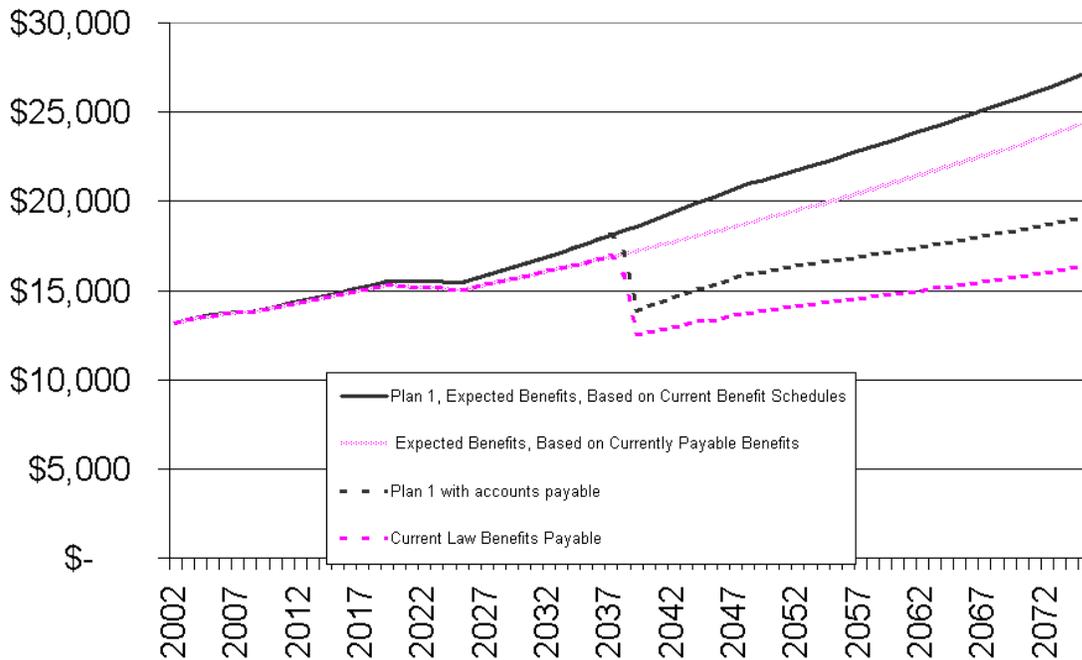
\* \$11,832, \$19,536 and \$25,812 are currently scheduled for low, medium, and high earners respectively but the system is projected to be 27.6% underfunded in 2052. Under the assumption that currently scheduled benefits are met, then the total expected benefit with personal accounts would be \$12,888, \$21,864 and \$29,544 respectively.

\*\* Expected benefits with accounts assume individual invests in a 50/50 stock/bond portfolio earning an annual real rate of return, net of administrative expenses, of 4.6%. Upon retirement, the individual is assumed to have converted to a variable annuity invested in the same portfolio. Actual benefits may be higher or lower than those reported here depending on realized investment returns.

## Low Earner Initial Benefit at Age 65



## Average Earner Initial Benefit at Age 65



### *Fiscal Sustainability Assessment*

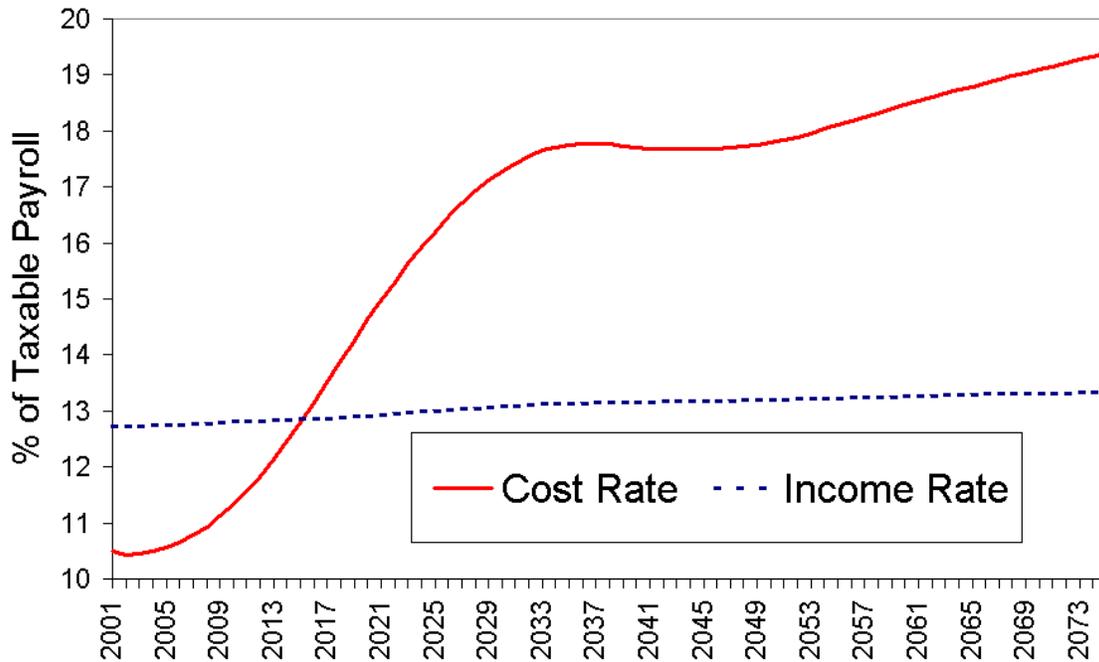
Model 1 as scored does not change the qualitative financing challenge facing the system within the valuation period. It devotes a transition investment to the system in the first four decades, and it would improve the program's annual cash flows from 2043 onward.

Within the basic framework of a two percent account with a 3.5 interest rate offset, many basic measures below show the same results whether the Model is scored as a two percent contribution from payroll taxes (with a larger commitment of general revenues to the Trust Fund) or a one percent contribution from payroll taxes in combination with a one percent contribution from general revenues (with a somewhat smaller commitment of general revenues to the Trust Fund.) Only for the solvency and actuarial balance measures are these treated differently, so both constructions are shown in these measures for purposes of illustration.

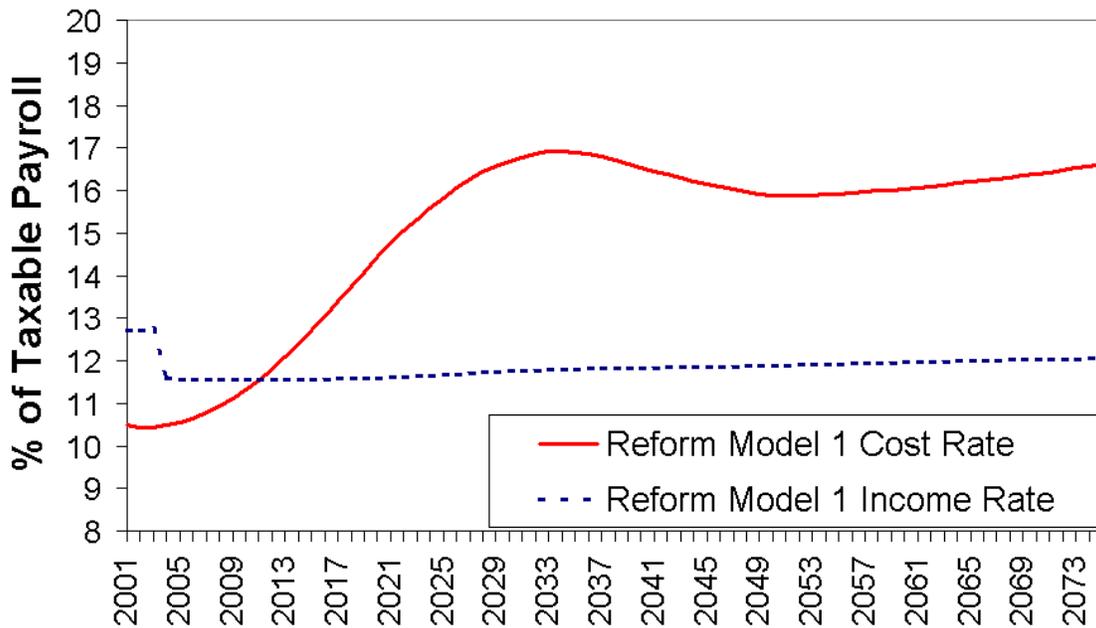
#### *Positive Annual System Cash Flow Within Valuation Period:*

Under current law, Social Security faces perpetually rising cash flow shortfalls. As the following chart shows, these deficits are projected to begin in 2016, rise to 4 percent of taxable payroll within thirty years, and reach 6 percent of taxable payroll by 2075. Model 1 reduces the shortfall by approximately 1.5 percentage points by the end of the period, an improvement of approximately 24 percent. However it does not eliminate these permanent deficits within the 75-year valuation period, nor would it return the system to positive annual cash flow within that time.

Under current law, Social Security's annual costs will exceed its income in 2016, with perpetually increasing deficits thereafter.



**Under Model 1, Long-Term Cash Deficits Would Be Reduced By Approximately 24 Percent**



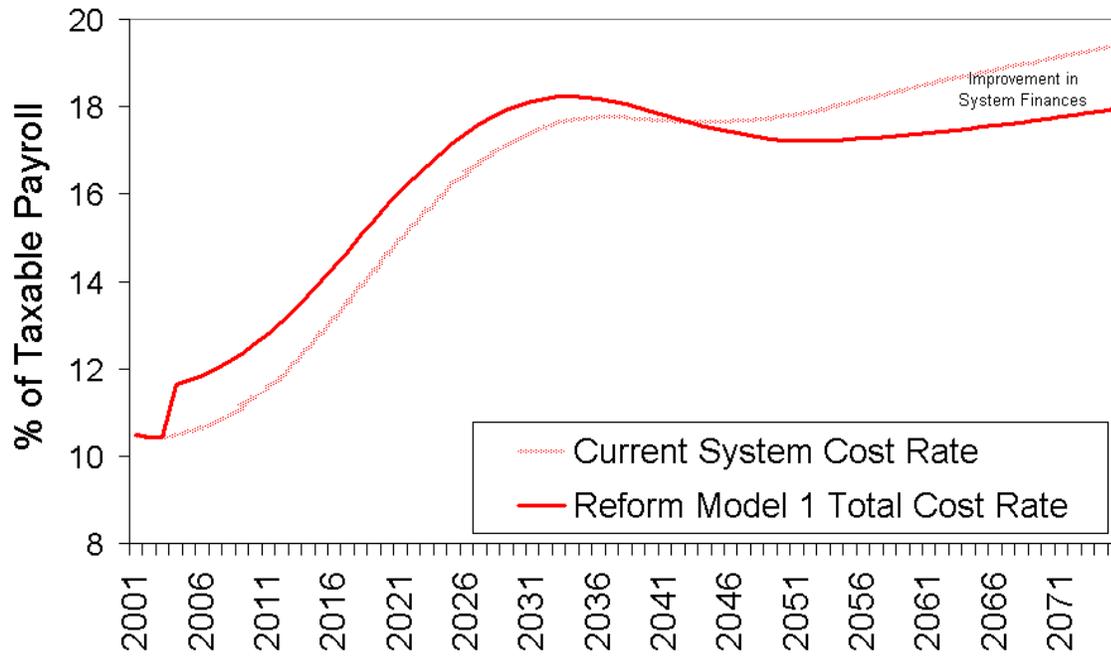
Under Reform Model 1, the present value of the program's cash deficits over the next 75 years would remain qualitatively the same as under current law – a slight increase of \$200 Billion in present value, or a 3.8 percent change. Reform Model 1 would increase expected benefits for participants but would not significantly alter the size of Social Security's fiscal imbalances within the valuation period. It would, however, distribute the financing burdens more equitably across generations, with some of the mounting outyear cash burdens moved closer in time. Outside the valuation window, the picture would improve substantially relative to current law.

If Reform Model 1 were structured as a 1 percent investment of payroll taxes accompanied by a 1 percent match from general revenues, the present value of the cash deficits within Social Security would be measured as having diminished. This, however, could give a misleading impression that such a method of financing would diminish the total costs of Reform Model 1. It would not. Counting the cost of a 1 percent match from general revenues would bring the total cost of Reform Model 1 up to the same figures given above.

*Reductions in the Rate of Growth in Long-Term System Costs as a Percent of GDP:*

Social Security's burden on future taxpayers is usefully measured by its expenditures as a percentage of taxable payroll. As shown previously, under current law Social Security's burden on future taxpayers is projected to rise quickly during the next thirty years, from its current level of 10.5 percent of taxable payroll to over 17 percent of taxable payroll by 2030. Thereafter, the burden continues to grow, albeit at a somewhat slower pace. By 2075, the burden will exceed 19 percent of taxable payroll. Model 1's policies would have little beneficial long-term impact on the growth in Social Security's burden. The model's expenditures would reach a maximum of 18.2 percent of taxable payroll in 2034, assuming a 67 percent participation rate, including the amount of annual investments in personal accounts. Relative to GDP, costs by 2075 would have grown 16 percent less than under current law. In the following years, Model 1's policies would gradually reduce system costs relative to current law.

## Under Reform Model 1, Gains for Beneficiaries Would Be Accompanied By Long-Term Fiscal Improvements



*Improvements in 75-Year Actuarial Balance:*

If structured as a 2 percent contribution from payroll taxes, the 75-year actuarial balance would be projected to have worsened by 0.32 percent of payroll over the valuation period. Improvements in actuarial balance would occur only after the 75-year valuation period. If structured as a 1 percent payroll tax contribution matched by a 1 percent contribution from general revenues, it would be deemed to have improved by 0.29 percent. It is important to note, however, that this is an artifact of the method of computing solvency and that the two methods of construction are *identical* in terms of their effects on beneficiaries and taxpayers. Either way, the total revenues required to achieve solvency would be exactly the same. This example highlights the limitations of this traditional measure of the fiscal health of the program.

*Improvement in System Solvency:*

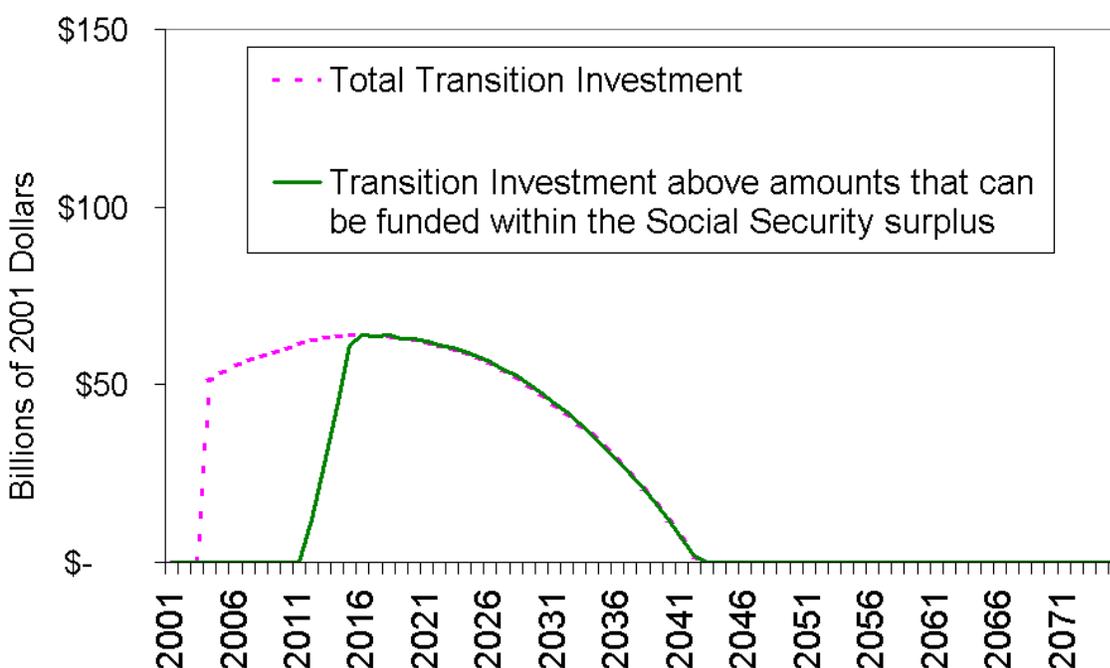
Despite a slight improvement in long-term fiscal pressures, Reform Model 1 would increase short-term revenue requirements to maintain Trust Fund liquidity. If structured as a contribution of 2 percent from payroll taxes, these additional revenue requirements to maintain Trust Fund liquidity would be needed starting in 2030. If structured as a 1 percent contribution from payroll taxes plus a 1 percent match from general revenues, they would be needed starting in 2034. (Note again that revenues required to retain liquidity in the Trust Fund, an issue that would not arise for decades, are a different concept than the “transition investment” as explained in the Methodology section.)

## Transition Financing

For Reform Model 1, no new “transition” cash would be needed before 2012 when the investment in personal accounts for the first time exceeds current-law surpluses. The “transition” financing requirements begin comparatively small – \$12 Billion annually in 2012 – and they would grow to a maximum of \$64 billion annually from 2016-2018. Thereafter the amount of new cash requirements for the new system would diminish, until in 2043, the new system would be permanently less expensive than the old.

These figures presume that only Social Security cash surpluses are available to provide transition financing. Through 2043, a total of \$1.1 trillion in transition investments would be required, in present value terms. Assuming that Social Security cash surpluses are available to provide such financing, the remaining transition investment required would be approximately \$700 billion in present value terms. Were Congress to “lockbox” both cash and interest surpluses as previously intended, transition financing needs would be postponed by additional years.

### Reform Model 1 Transition Investment with 2/3 Participation



*Impact on Unified Federal Budget:*

Reform Model 1 would take the longest of the three plans to have a net positive impact on the annual federal cash budget, doing so only after 2043, assuming 67 percent participation. By 2075, the net positive effect would be \$162 billion in constant 2001 dollars. The largest annual negative effect that this Reform Model would have on federal cash operations would be approximately \$64 billion in 2001 dollars, annually, from 2014-2018. This is considerably less than the current Social Security surplus, if interest is included.

## ***Reform Model 2: Voluntary Progressive Personal Accounts Combined with an Inflation-Indexed but more Progressive Traditional System***

### **The Model:**

Reform Model 2 establishes a voluntary personal account, without raising taxes or requiring additional worker contributions. Model 2 enables all future retirees to receive an inflation adjusted Social Security benefit that is at least as great as today's retirees. Model 2 establishes new poverty protections beyond what the current program provides. As a result, the purchasing power of the benefit expected by a low-wage worker in 2052 would be approximately 75 percent higher than the Social Security benefit received today by a retiree with a low-wage work history. The approach eliminates Social Security's permanent deficits and places the program firmly on a fiscally sustainable path within the 75-year window.

### **Key Elements:**

#### **Personal Accounts**

Workers who have not yet reached age 55 (as of January 1, 2002) would be given the opportunity, starting in 2004, to redirect 4 percentage points of their payroll taxes, up to an annual maximum of \$1,000, to a personal account. The amount of the maximum annual contribution of \$1,000 (as of 2002) would be indexed annually by wage growth.

In exchange for the benefits generated by the personal account, traditional Social Security benefits would be offset by the amount of personal account contributions compounded at a real interest rate of 2 percent (in practice the yield on Treasury bonds less 100 basis points). So long as the career-average net yield on the personal account exceeds this 2 percent real rate, a worker would receive higher total retirement benefits by opting for the personal account. Even the most conservative portfolio available, consisting only of government bonds returning about 3 percent annually, would exceed the offset rate and result in higher total benefits.

#### **Traditional Social Security Benefits**

Benefits in the traditional Social Security system would be indexed to price inflation rather than national wage growth beginning in 2009. The wage-indexing policy, instituted in 1977, has never been fiscally sustainable. Twenty-two of the 24 Social Security Trustees Reports issued since the policy was adopted have declared the program to be insolvent. The new price-indexing policy slows the growth in future benefits. But, it ensures that future retirees will receive inflation-adjusted benefits that are at least as high as the benefits received by today's retirees.<sup>42</sup>

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<sup>42</sup> In practice, the policy would be implemented by multiplying the PIA bend point factors (the bend points would remain indexed to wages) by the ratio of the Consumer Price Index to the Average Wage Index in successive years.

New poverty protections are established. A new minimum benefit provision would increase benefits for a 30-year minimum wage earner by approximately 40 percent by 2018 relative to the price indexed benefit level.

Benefit growth for lower-wage workers would be accelerated relative to current law between 2009 and 2018. Thereafter, these initial benefits would grow at the rate of inflation. By 2018, a 30-year minimum wage worker would receive benefits in an amount at least 20 percent above the poverty line, a protection that does not exist in the current system.

Benefits for widows would be increased to as much as 75 percent of the combined benefits that would be received by the couple if both were still alive, versus 50-67 percent under current law. To target this benefit increase to widows most in need, benefits under this provision would be increased only to the level of the benefit received by an average retired worker beneficiary.

### **Transition Transfers**

In order to maintain the ability to pay benefits throughout the 75-year period, additional revenue would likely be needed (in years 2025 through 2054 under the assumptions used for these estimates). The Reform Model would provide for transfers from the General Fund of the Treasury in amounts needed for such years. However, because of substantial expected cash flow surpluses later in the period, and beyond, these transfers could be repaid.

## *Benefits*

Under Model 2, workers who opt for personal accounts can expect to receive retirement benefits that are higher than either the inflation adjusted level of benefits currently paid to retirees, or the benefits the existing system can afford in the future.

The accompanying table displays expected benefit levels of workers who choose personal accounts and compares these levels to benefits received by current retirees. All benefits are in 2001 dollars. For workers who are currently aged 35 and who retire in 2032, the purchasing power of benefits is expected to be 17-32 percent higher than the purchasing power of benefits received today. For a younger worker who enters the workforce in 2009 when Model 2 price-indexing policy begins, benefits are expected to be 51-78 percent higher.

Under Model 2, the Social Security system is designed to become more progressive than the current program. As the accompanying table shows, for each future retiree cohort, low-wage workers expect the largest benefit increases and high-wage workers expect the smallest increases. This greater progressivity results from two policies. First, workers can redirect 4 percentage points up to a limit, set initially at \$1,000. A worker earning \$25,000 can redirect 4 percentage points of the payroll taxes on his entire salary. A worker earning \$50,000, however, can redirect only 2 percentage points of the payroll taxes on his salary. Accumulations in personal accounts are assumed to be used to purchase variable annuities at retirement. Second, as part of Model 2's improved protections against poverty, benefit levels paid to all low-wage workers are raised.

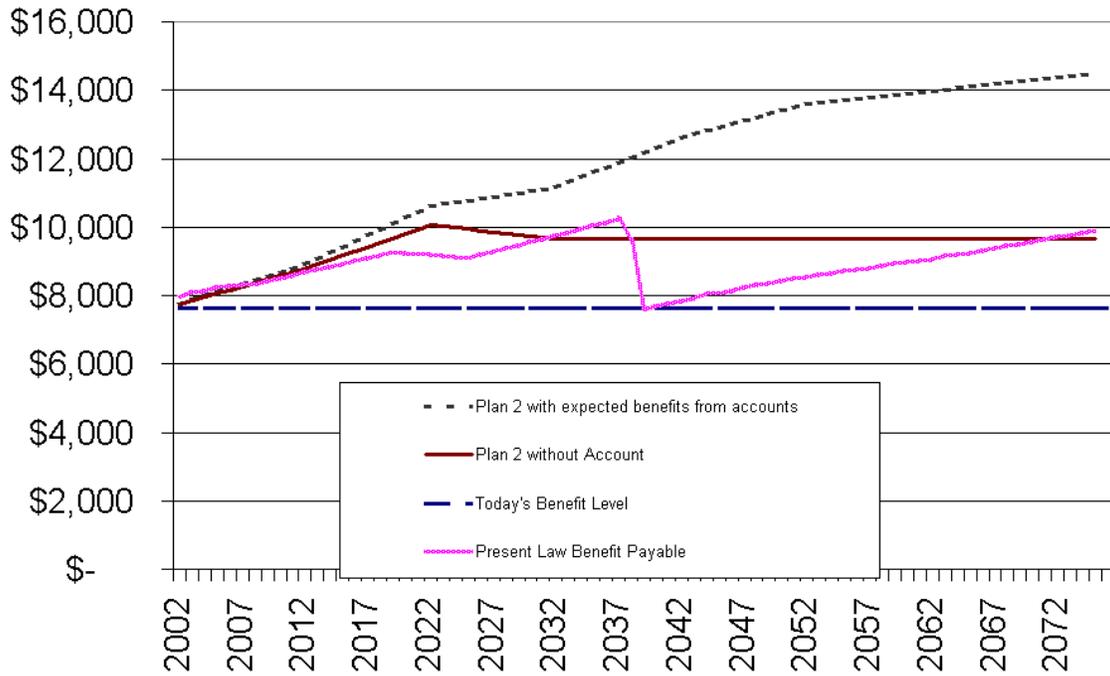
For workers who do not opt for personal accounts, initial benefit levels would grow with inflation. That is, a medium-wage worker could expect the same initial benefit in real terms, (increased by the rate of inflation) as was received by a medium-wage worker in the previous year. The exception to this would be for lower-wage workers, who would benefit from the Reform Model's added protections against poverty. A low-wage worker in 2052 would receive benefits that are 27 percent higher in real terms than those received by a low-wage worker today.

<b>Plan 2: Price indexed system</b>						
				<b>Reform Model Benefits</b>		
<b>Year</b>	<b>Relative Earnings</b>	<b>Today's benefit levels</b>	<b>Current Law benefit</b>	<b>Expected benefit with account</b>	<b>Increase relative to today's benefit</b>	<b>Additional increase due to account</b>
2032	Low	\$7,644	\$9,756	\$11,160	\$3,516	\$1,488
	Medium	\$12,624	\$16,116	\$15,444	\$2,820	\$2,256
	High	\$16,392	\$21,288	\$19,680	\$3,288	\$2,268
2052	Low	\$7,644	\$8,568*	\$13,608	\$5,964	\$3,936
	Medium	\$12,624	\$14,148*	\$20,016	\$7,392	\$6,828
	High	\$16,392	\$18,696*	\$24,684	\$8,292	\$7,272

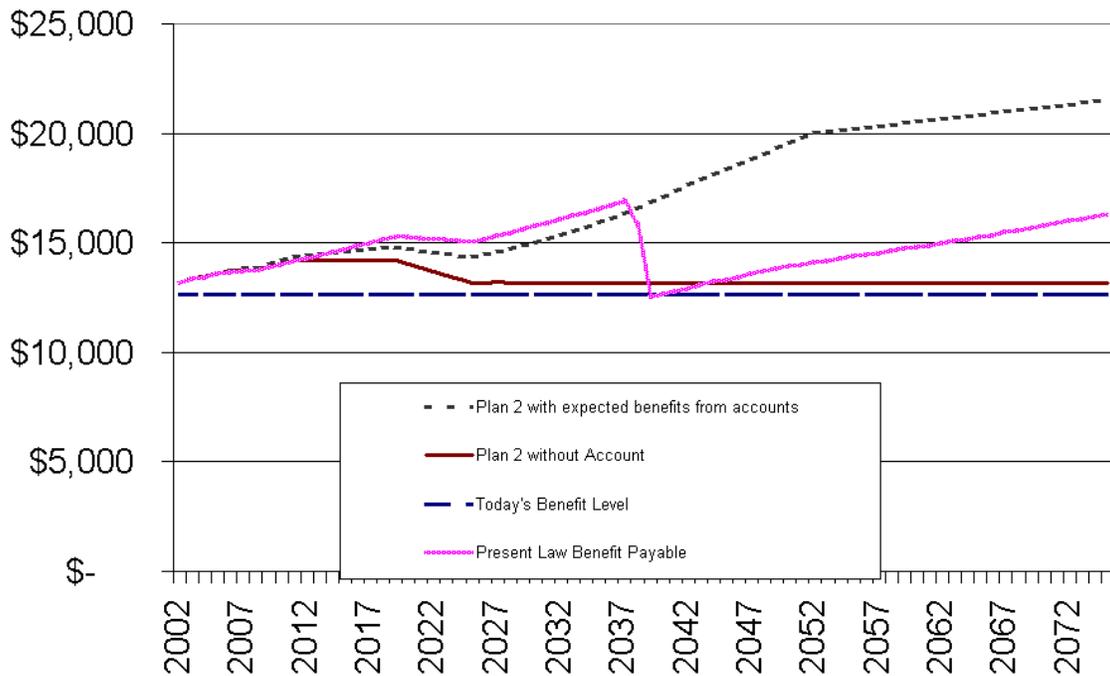
\* \$11,832, \$19,536 and \$25,812 are currently scheduled annual benefits for low, medium, and high earners respectively but the system is projected to be 27.6% underfunded in 2052. For 2032, promised and payable benefits are identical.

\*\* Expected benefits with accounts assume individual invests in a 50/50 stock/bond portfolio earning an annual real rate of return, net of administrative expenses, of 4.6%. Upon retirement, the individual is assumed to have converted to a variable annuity invested in the same portfolio. Actual benefits may be higher or lower than those reported here depending on realized investment returns.

### Low Earner Initial Benefit at Age 65



### Average Earner Initial Benefit at Age 65



## *Fiscal Sustainability Assessment*

Model 2 significantly improves Social Security's financial health and greatly reduces its burden on future workers. Of the three models presented in this report, Reform Model 2 makes the most progress toward fiscal sustainability in the sense of reducing the need for additional revenues. This section of the report assesses Model 2's progress against the fiscal sustainability criteria adopted by the Commission.

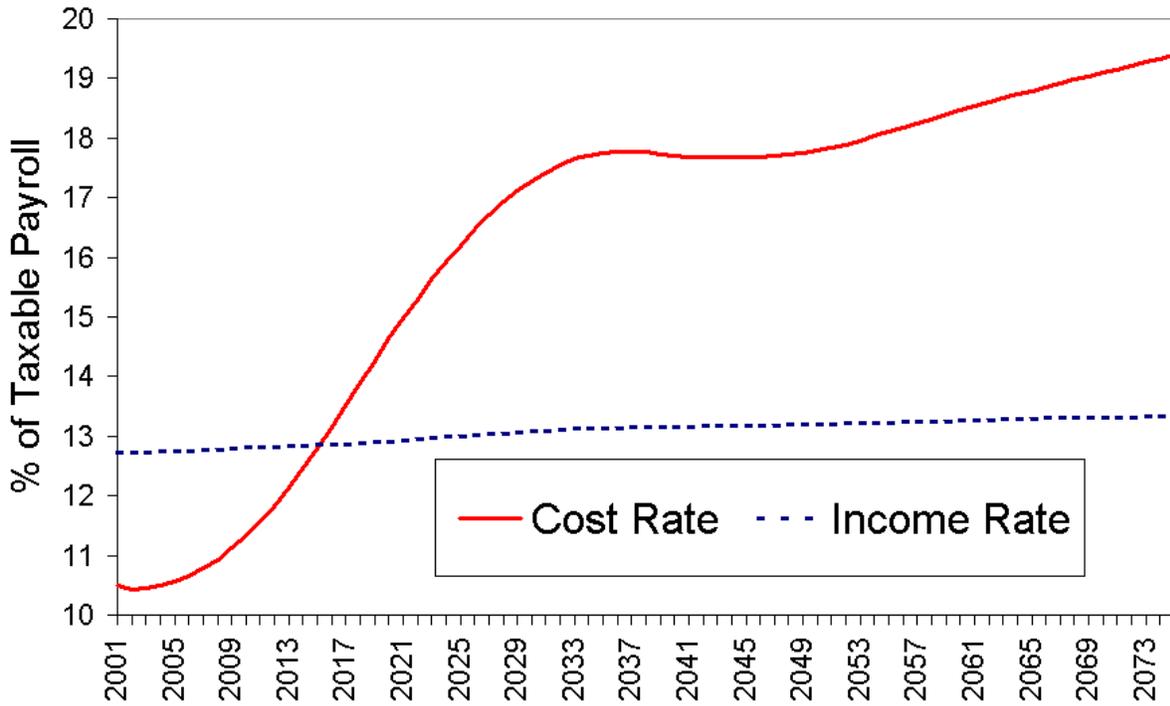
### *Positive Annual System Cash Flow Within Valuation Period:*

Under current law, Social Security faces perpetually rising cash flow shortfalls. As shown previously, these deficits are projected to begin in 2016, rise to 4 percent of taxable payroll within thirty years, and reach 6 percent of taxable payroll by 2075. Model 2 eliminates these permanent deficits by the end of the 75-year valuation period due to restraint in benefit growth and financially attractive personal accounts, without relying on general revenue transfers, or higher taxes. As the following chart shows, under Model 2 Social Security deficits peak at 4 percent of taxable payroll in 2029 and decline rapidly thereafter. The program's annual deficits would be eliminated by the year 2059. During the following years, the current Social Security program's perpetually rising deficits under current law would be replaced by perpetually rising surpluses.<sup>43</sup>

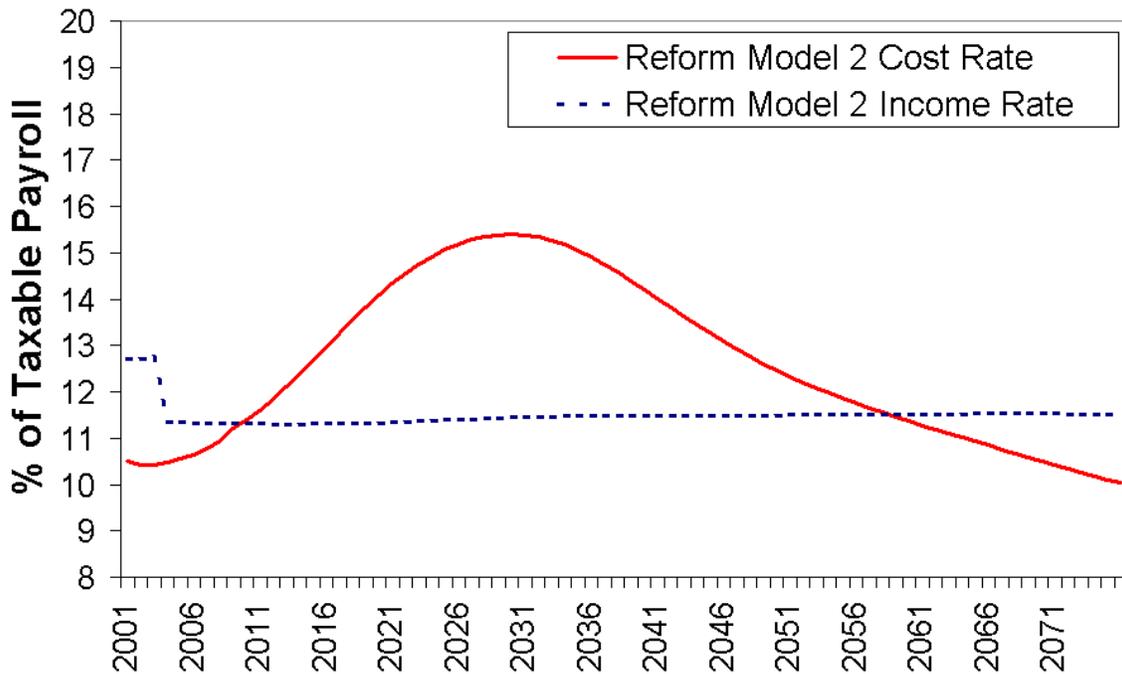
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<sup>43</sup> Personal accounts would be highly attractive under this framework, providing significantly higher benefits without additional taxes. As a result, participation rates may exceed 67 percent. A higher participation rate would accelerate slightly the return to permanent cash surpluses and increase the size of the surpluses at the end of the valuation period.

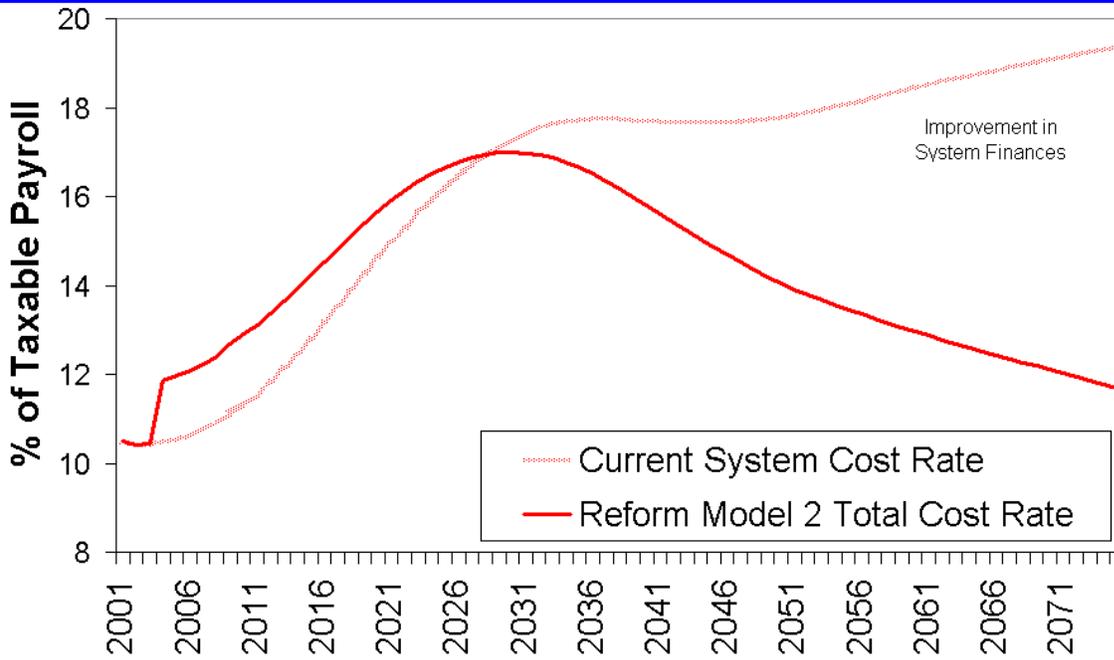
Under current law, Social Security's annual costs will exceed its income in 2016, with perpetually increasing deficits thereafter.



**Reform Model 2 Restores Positive Cash Flow by 2059, Surpluses Thereafter**



## Reform Model 2 Would Vastly Improve System Finances Relative To Current Law



### *Reductions in the Rate of Growth in Long-Term System Costs as a Percent of Payroll and GDP:*

Social Security's burden on future taxpayers is usefully measured by its expenditures as a percentage of taxable payroll. As previously shown, under current law Social Security's burden on future taxpayers is projected to rise quickly during the next thirty years, from its current level of 10.5 percent of taxable payroll to over 17 percent of taxable payroll by 2030. Thereafter, the burden continues to grow, albeit at a somewhat slower pace. By 2075, the burden will exceed 19 percent of taxable payroll. Model 2's policies would initially slow the growth in Social Security's burden. The reform model's expenditures to pay traditional Social Security benefits would reach a maximum of 15.4 percent of taxable payroll in 2030. (Under Commission projections, an additional 1.6 percent of national payroll would be invested in personal accounts.) In the following years, Model 2's policies would gradually reduce Social Security's burden. By the end of the valuation period in 2075, the program's expenditures as a percent of GDP would fall below its level today.

### *Improvements in 75-Year Actuarial Balance:*

The price-indexing policy, coupled with Model 2's increases in traditional benefits for low-wage workers and survivors, but without personal accounts, brings the program into long-term actuarial balance. That is, the actuarial deficit of -1.86 percent of payroll is eliminated entirely. The addition of personal accounts and benefit offsets creates an actuarial imbalance of 0.7 percent of payroll for the current valuation period. However, it would increase the size of system cashflow surpluses that appear late in the valuation period and beyond that would restore actuarial balance in the future. This imbalance for the current valuation period stems, in part, from the fact contributions from workers who opt for personal accounts are counted as a reduction in Social Security revenue, but much of the benefit reductions that result from these redirected contributions occurs beyond the valuation period, and hence, is not reflected in the actuarial balance. The Office of the Social Security Actuary has identified the amount of revenues that are necessary to maintain solvency (the ability to pay benefits) throughout the next 75 years and thus assure actuarial balance under Model 2 under the Commission's assumptions for participation in the accounts. Without such general revenues, Model 2 would be projected to reduce Social Security's actuarial imbalance by 62 percent, from its current 1.86 percent of payroll to 0.71 percent of payroll. With this temporary transition financing, the Reform Model would maintain solvency through the period and restore actuarial balance. It should be noted that the Social Security system would be in a position to repay the temporary transition financing due to permanent cash surpluses beginning in 2059.

### *Improvement in System Solvency:*

Social Security's finances would be greatly improved. Model 2 would significantly reduce the amount of general revenue required to finance benefit payments. Without reform, Social Security is expected to require over \$20 trillion of additional revenues (in

2001 dollars) to finance its benefit payments over the 75-year valuation period. Model 2 is projected to reduce the requirement by 68 percent. The reduction is less when measured in present value terms (45 percent) since the major portion of savings generated by the model's benefit growth restraint occurs during the latter half of the 75-year valuation period.

Model 2 includes a temporary transfer of general revenues to ensure that solvency is achieved and full benefits can be paid. Under current projections, these transfers would begin in 2025 and would continue until 2054. The largest transfers would occur during the years 2030-2040 and, during this decade they would average 1.2 percent of Gross Domestic Product. These transfers are projected to be about 6 percent of the non-social security portion of the federal budget. Thus, the transfers would produce a strain on the rest of the federal budget, but not an unmanageable one. After 2040, the required transfers would decline quickly.

#### *Transition Financing*

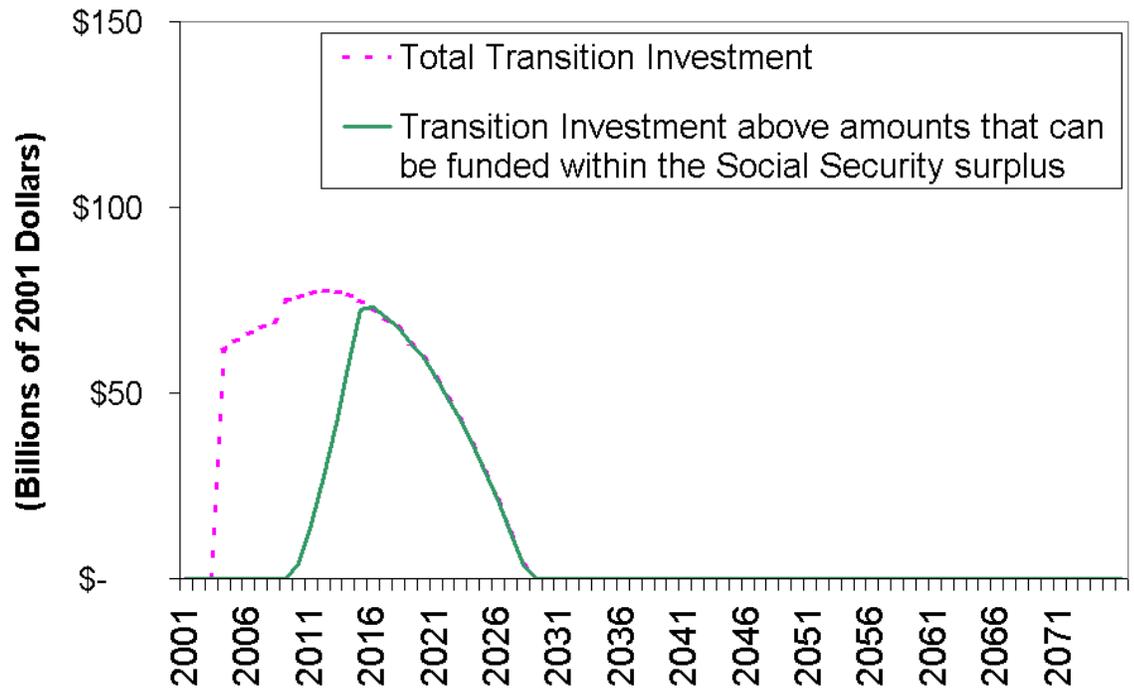
Reform Model 2 would significantly reduce fiscal pressures on the rest of the federal government relative to current law.

For Reform Model 2, no new "transition" cash would be needed before 2010 when the investment in personal accounts for the first time exceeds current-law surpluses. The "transition" financing requirements begin comparatively small – \$4 billion in real dollars as of 2010 – and they would grow to a maximum of \$73 billion (in 2001 dollars) in the years 2015-16. Thereafter the amount of new cash requirements for the new system would diminish, until in 2029, the new system would be permanently less expensive than the old.

In sum, the total transition investments under Reform Model 2 would be approximately \$900 billion in present-value terms. The amount required beyond that which is already accounted for by projected Social Security cash surpluses under Model 2 is approximately \$400 billion in present-value terms.

Again, all of the figures above presume that only Social Security cash surpluses are available to provide transition financing. Were Congress to "lockbox" both cash and interest surpluses as previously intended, transition financing needs would be postponed by additional years.

**Reform Model 2 Transition Investment with 2/3 Participation**



*Impact on Unified Federal Budget*

Reform Model 2 would have a net positive impact on the federal cash operations by 2029, with positive gains increasing throughout the valuation period and reaching \$816 Billion annually (in 2001 dollars) by 2075. The largest negative impacts on the federal budget would be \$78 Billion (in 2001 dollars) in years 2012-2013. If no one opted for personal accounts, net improvements in the federal budget balance would be positive almost throughout the valuation period, but less by 2075 than under Commission assumptions for participation.

### *Advantages of Reform Model 2:*

- All workers would expect to benefit from personal accounts (due to the low 2 percent offset rate), but lower-wage workers would benefit the most, because of the progressive formula for funding the accounts.
- Those who opt for personal accounts would not be required to pay any additional money.
- Reform Model 2 would significantly raise low-wage workers' benefits relative to current law. The bill would establish a new poverty protection so that no lifetime low-wage participant would face poverty in old age. Benefits for minimum wage workers with at least 30 years of labor force attachment would be raised to 120 percent of the poverty line, even if they do not opt for personal accounts. A low-wage workforce entrant today who opts for personal accounts can expect to receive combined Social Security benefits equal to those received by an average retiree today, even after adjusting for inflation.
- Social Security's permanent deficits would be eliminated without reliance on permanent general revenue transfers.
- Reform Model 2 would significantly increase benefits for widows, who are among the elderly at greatest risk of poverty.
- Social Security's burden on future generations would be significantly reduced, returning to today's levels within the valuation period.

## ***Reform Model 3: Voluntary Add-On Accounts with Matches from Payroll Taxes Overlaying a Traditional System Balanced with a Blend of Revenue and Outlay Changes***

### **THE MODEL**

Reform Model 3 is based on the premise that restoring Social Security to solvency is essential, but maintaining scheduled benefits and existing wage replacement rates is also important. Reconciling these two objectives for those who elect personal accounts requires additional revenues. These revenues would take the form of dedicated revenue transfers, starting at 0.34 percent of program taxable payroll, rising to 0.86 percent of taxable payroll by 2075, and averaging 0.63 percent throughout the 75-year valuation period. Congress would be able to choose from a variety of sources for making such revenues available to the Social Security system.<sup>44</sup>

#### ***Key Elements:***

##### **Personal Accounts**

Workers who are under age 55 at the beginning of 2002 would be given the opportunity to invest in voluntary personal accounts beginning in 2004. The deposit in personal accounts would be triggered by a voluntary contribution of an additional 1 percent of the participant's wages, matched by a 2.5 percent contribution (up to an annual maximum of \$1,000, which would be indexed each year to national wage growth) from their current payroll taxes. The requirement that the personal account be triggered by a voluntary contribution of an additional 1 percent of pay will increase national savings. The voluntary contribution would be subsidized in a progressive manner by rebating a portion of the amount through a refundable tax credit.

In exchange for the benefits generated by the personal account, traditional Social Security benefits would be offset by the amount of personal account contributions from the match compounded at a real interest rate of 2.5 percent. Accordingly, even if individuals invested only in government bonds returning 3 percent, their total retirement benefits will increase due to the accounts.

##### **Traditional Social Security Benefits**

Initial Social Security benefits would grow at a rate that is expected to be approximately halfway between wage indexing and price indexing. This approach would maintain intergenerational equity by holding roughly constant the relative amount of lifetime

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<sup>44</sup> Some members of the Commission believed that a substantial portion of this 0.63% should come from an increase in the payroll tax base, while leaving the payroll tax rate the same. They suggested that the payroll tax base should be stabilized as a percentage of the total U.S. wage bill closer to its level during the last two decades. However, this suggestion was deemed inconsistent with the principles in the executive order establishing the Commission and was therefore not included in the final version of this plan.

benefits from Social Security as longevity increases, without raising Social Security's normal retirement age.<sup>45</sup>

Work would be rewarded and early retirement penalized by changing the actuarial adjustments for early and late retirement to reflect additional payroll taxes contributed. This change is designed to encourage labor force participation among workers age 62-70. The policy would be phased in from 2009 through 2013.

The 15 percent bend point factor, affecting the participants with the highest incomes, would be gradually reduced to 10 percent from 2009 through 2028. This policy is designed to achieve savings from persons who can most afford to forgo some Social Security benefits.

As in Model 2, benefit growth for lower-wage workers would be accelerated relative to current law between 2009-2018. By 2018, a worker who works for 30 years at the minimum wage would be eligible for a benefit at least as high as the poverty level, and would increase relative to poverty for subsequent retirees. For a 40-year minimum wage worker, this benefit would equal 111 percent of the poverty level, and would increase relative to poverty for subsequent retirees.

As in Model 2, benefits for widows of couples with below-average earners would be increased to as much as 75 percent of the combined benefits that would be received by the couple if both were still alive, versus 50-67 percent under current law. To target this benefit increase to widows most in need, benefits under this provision would be increased only to the level of the benefit received by an average retired worker beneficiary.

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<sup>45</sup> The adjustment would be based on actual changes in period tables 10 years prior. For example, the increased life expectancy between 2010 and 2015 would be used to adjust the initial benefits downward over 2020-2025. This gradual adjustment process would give people ample time to compensate by planning to work longer or save more privately.

## **Transition Transfers**

In addition to the dedicated revenue transfers described above, additional revenue would be needed, as in Model 2. In order to maintain the ability to pay benefits throughout the 75-year period, additional revenue would likely be needed (in years 2034 through 2063 under the assumptions used for these estimates). The plan would include transfers from the General Fund of the Treasury in amounts needed for such years. However, if expected cash flow surpluses later in the valuation period and beyond materialize as a result of the provision of additional revenues under this Reform Model, these transfers could be repaid.

## Benefits

Under Model 3, workers who opt for personal accounts can expect to receive retirement benefits significantly higher than either the inflation adjusted level of benefits currently paid to retirees, or the benefits that are currently scheduled by the existing program.

The table below displays expected benefit levels of workers who choose personal accounts and compares these levels to benefits received by current retirees. All benefits are in 2001 dollars. For workers who are currently age 35 and retire in 2032, the purchasing power of benefits is expected to be 38-43 percent higher than the purchasing power of benefits received today. For a younger worker who enters the workforce in 2009 when Model 3 benefit formula changes begin, benefits are expected to be 85-93 percent higher. These higher benefits are made possible in part by the additional one percent worker contribution required for participation in the personal accounts.

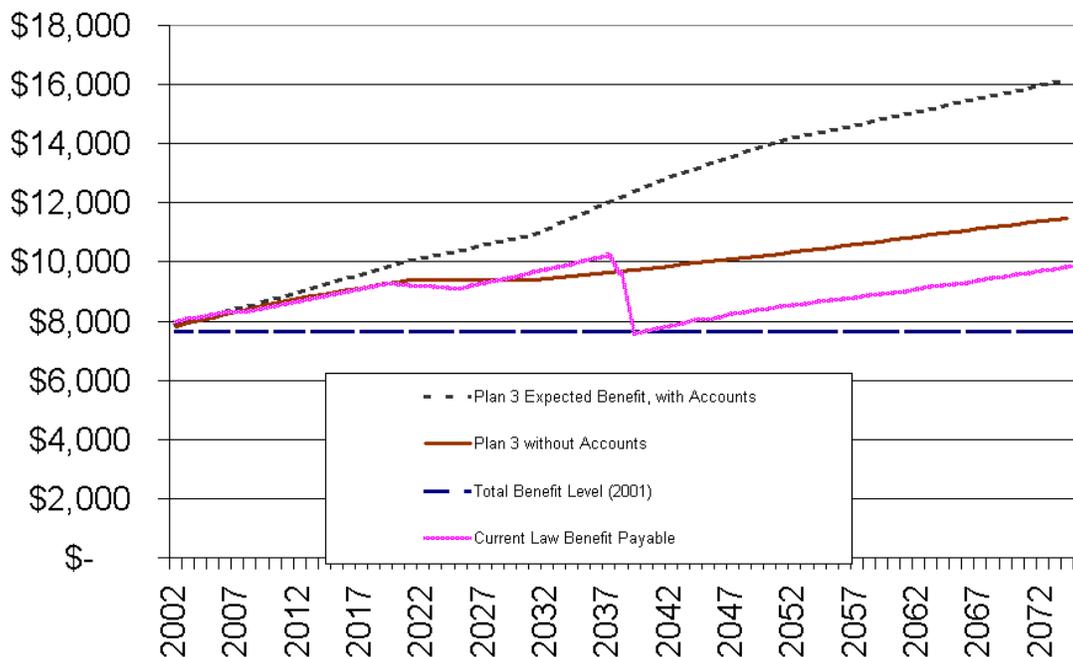
For workers who do not opt for personal accounts, initial benefit levels would grow at a rate that is roughly halfway between inflation and wage growth. The exception to this would be for lower-wage workers, who would benefit from the Reform Model's added protections against poverty. A low-wage worker in 2052 would receive benefits that are 35 percent higher in real terms than those received by a low-wage worker today.

<b>Plan 3: 1 percent "Add-on" contribution allows for benefit growth exceeding currently scheduled benefits</b>						
				<b>Reform Model Benefits</b>		
Year	Relative Earnings	Today's benefit levels	Current Law benefit	Expected benefit with account	Increase relative to today's benefit	Additional increase due to account
2032	Low	\$7,644	\$9,756	\$10,932	\$3,288	\$1,560
	Medium	\$12,624	\$16,116	\$17,412	\$4,788	\$3,456
	High	\$16,392	\$21,288	\$22,620	\$6,228	\$4,632
2052	Low	\$7,644	\$8,568*	\$14,112	\$6,468	\$3,828
	Medium	\$12,624	\$14,148*	\$23,796	\$11,172	\$8,496
	High	\$16,392	\$18,696*	\$31,668	\$15,276	\$11,952

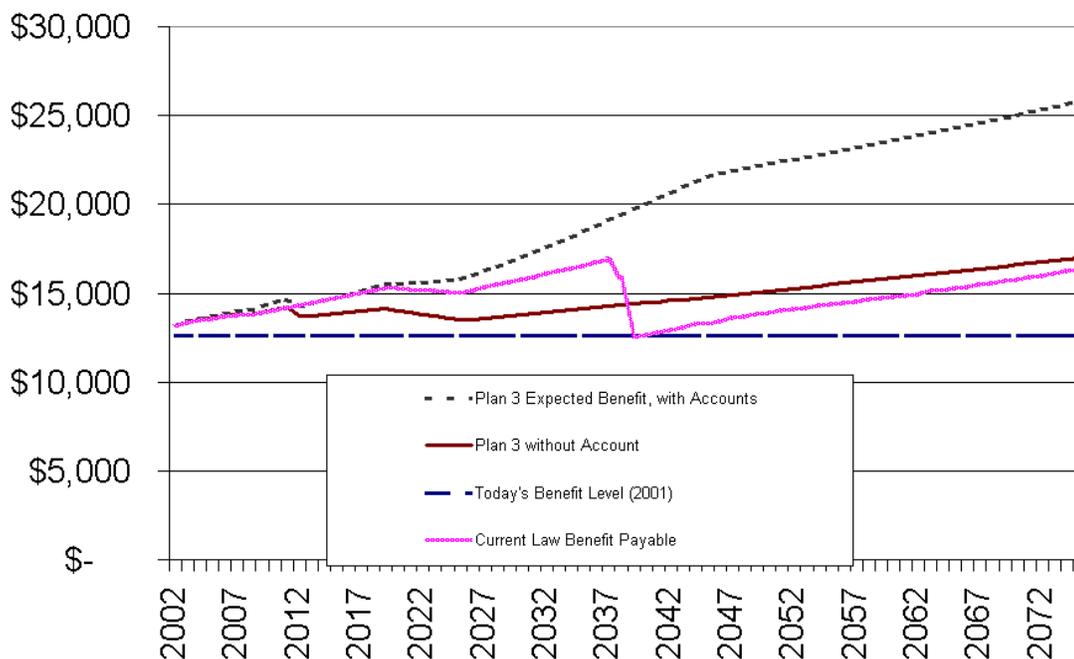
\* \$11,832, \$19,536 and \$25,812 are currently scheduled annual benefits for low, medium, and high earners respectively but the system is projected to be 27.6% underfunded in 2052. Under the assumption that currently scheduled benefits are met, then the total expected benefit with personal accounts would be \$12,888, \$21,864 and \$29,544 respectively. For 2032, promised and payable benefits are identical.

\*\* Expected benefits with accounts assume individual invests in a 50/50 stock/bond portfolio earning an annual real rate of return, net of administrative expenses, of 4.6%. Upon retirement, the individual is assumed to have converted to a variable annuity invested in the same portfolio. Actual benefits may be higher or lower than those reported here depending on realized investment returns.

### Reform Model 3: Low Earner Initial Benefit at Age 65



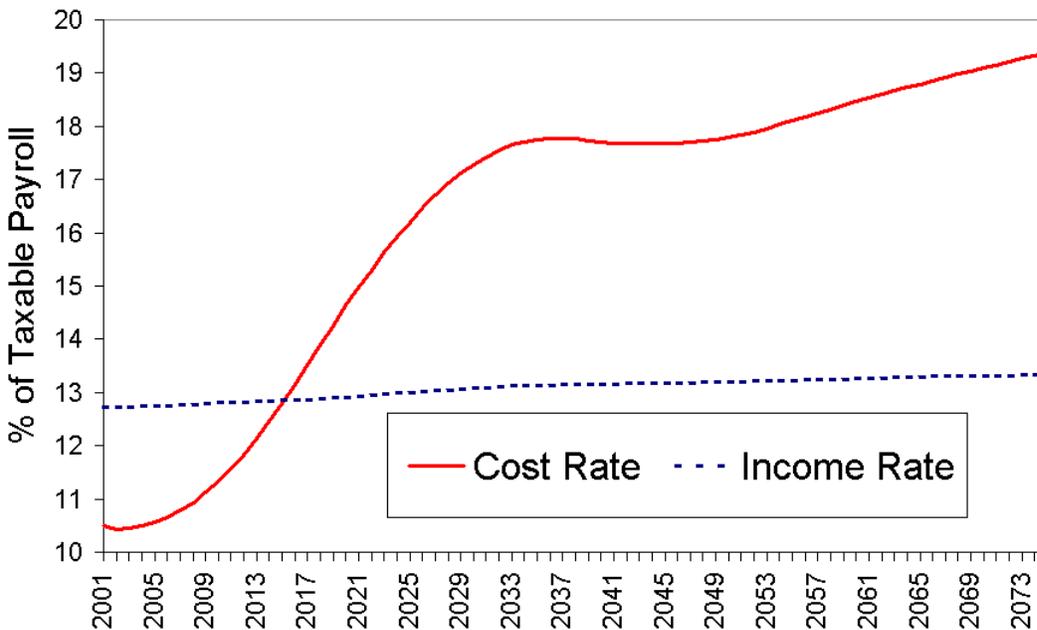
### Average Earner Initial Benefit at Age 65



## Fiscal Sustainability Assessment

Model 3 significantly improves Social Security's financial health and greatly reduces its burden on future workers. This section of the report assesses the Model 3's progress against the fiscal sustainability criteria adopted by the Commission.

Under current law, Social Security's annual costs will exceed its income in 2016, with perpetually increasing deficits thereafter.



### Positive Annual System Cash Flow Within Valuation Period:

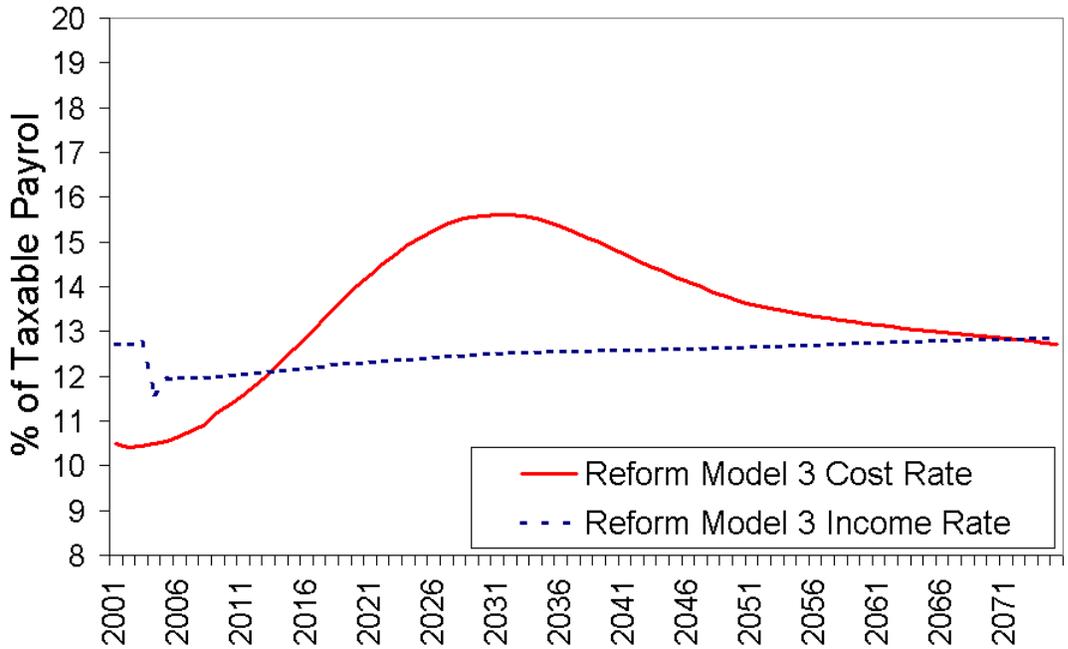
Under current law, Social Security faces perpetually rising cash flow shortfalls. As shown previously, these deficits are projected to begin in 2016, rise to 4 percent of taxable payroll within thirty years, and reach 6 percent of taxable payroll by 2075.

Model 3 contains a provision to permanently transfer new revenues to the Social Security program. As noted earlier, these revenues would take the form of dedicated revenue transfers, starting at 0.34 percent of national taxable payroll, and rise to 0.86 percent of taxable payroll by 2075. Over the entire 75-year valuation period, the permanent revenue transfer would average 0.63 percent of taxable payroll. Congress would be able to choose from a variety of sources for making such revenues available to the Social Security system. Including this revenue transfer in the projections for Model 3 would improve Social Security's cash flow position markedly. Social Security deficits would peak at just over 3 percent of taxable payroll in 2030 and the deficits would be eliminated in 2072.

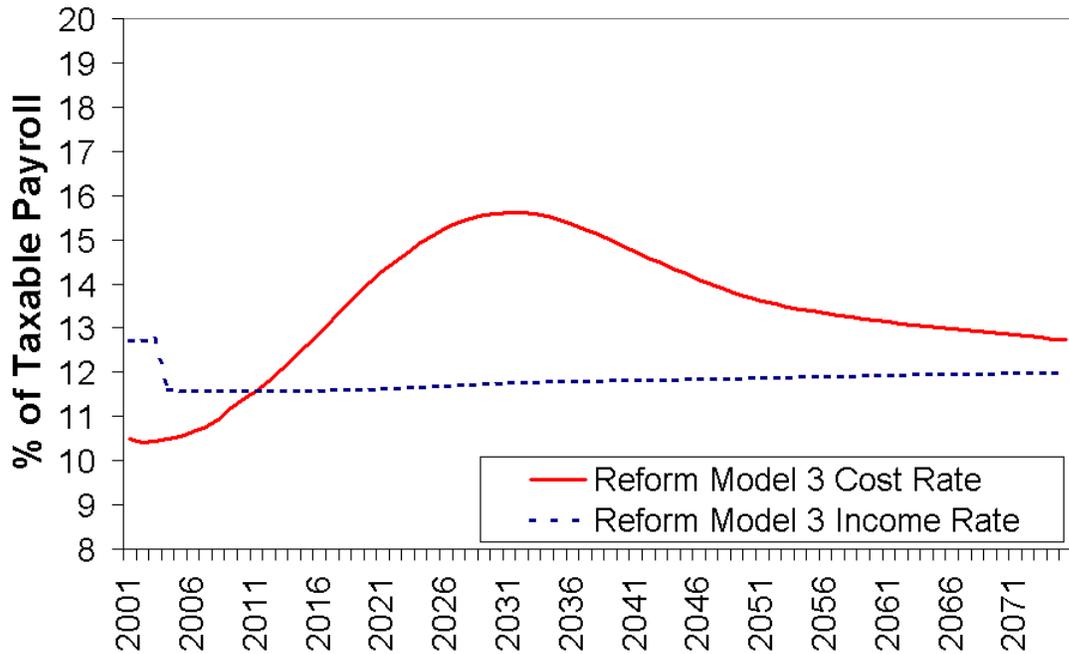
Because Model 3's projections of solvency depend on the provision of additional revenues to the Social Security program, we also present cash flow projections for Model 3 that recognize the financing from additional revenues that would remain for

Congress to determine. As the chart shows, Social Security deficits would then peak at 3.85 percent of taxable payroll in 2030 and decline rapidly thereafter, falling to 0.75 percent of payroll by the end of the valuation period.

**Reform Model 3: Income-Cost Rates With Additional Dedicated Revenues**

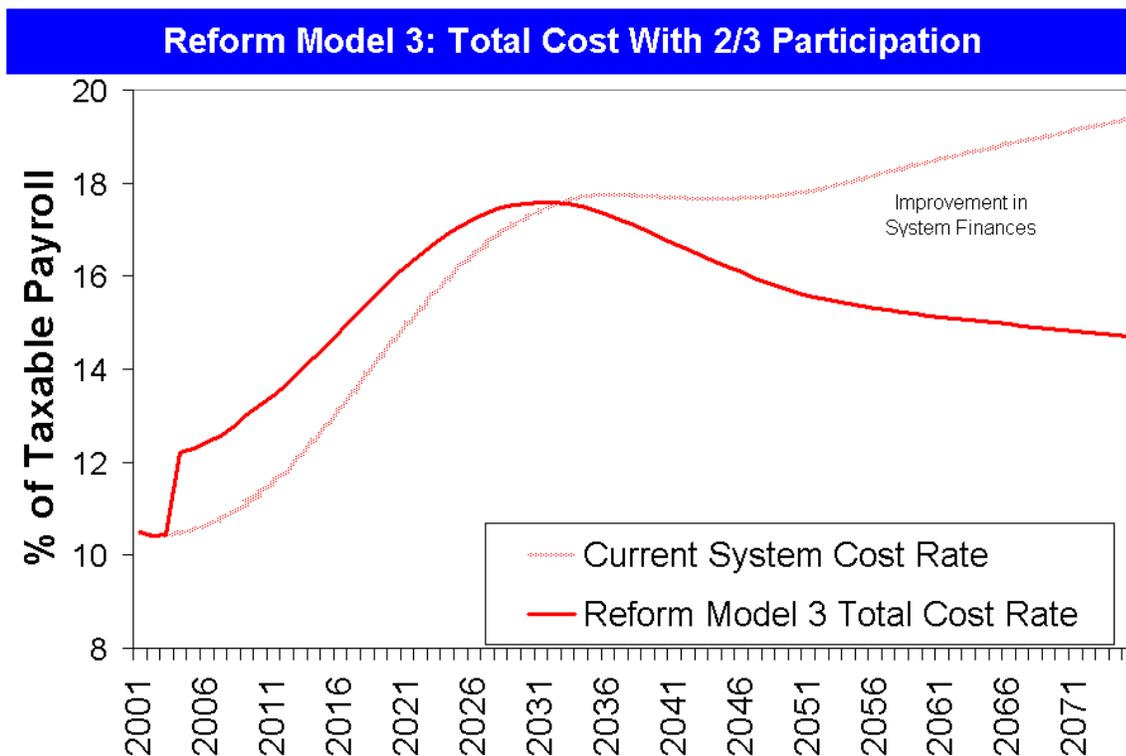


**Reform Model 3: Income-Cost Rates Without Additional Dedicated Revenues**



*Reductions in the Rate of Growth in Long-Term System Costs as a Percent of Taxable Payroll and GDP.*

Social Security's burden on future taxpayers is usefully measured by its expenditures as a percentage of taxable payroll. As previously shown, under current law Social Security's burden on future taxpayers is projected to rise quickly during the next thirty years, from its current level of 10.5 percent of taxable payroll to over 17 percent of taxable payroll by 2030. Thereafter, the burden continues to grow, albeit at a somewhat slower pace. By 2075, the burden will exceed 19 percent of taxable payroll. Model 3's policies would initially slow the growth in Social Security's burden. The reform model's expenditures for traditional Social Security benefits would reach a maximum of 15.6 percent of taxable payroll in 2032 (with another 1.3 percent of the nation's taxable wages invested annually in personal accounts). In the following years, Model 3's policies would gradually reduce Social Security's burden. By the end of the valuation period in 2075, the program's expenditures as a percent of GDP would fall to a level lower than today.



### *Improvements in 75-Year Actuarial Balance:*

Under Model 3, a combination of added revenues and changes to benefit growth would, in the absence of individual accounts, eliminate entirely the current-law actuarial deficit of -1.86 percent of payroll. The introduction of personal accounts results in an actuarial imbalance of 0.37 percent for the current valuation period. This imbalance stems, in part, from the fact contributions from workers who opt for person accounts are counted as a reduction in Social Security revenue, but benefit reductions that result from these redirected contributions occur beyond the valuation period, and hence, are not counted as a reduction in costs. Temporary transition financing would be provided to maintain solvency (i.e., the ability to pay benefits each year) and would thus restore actuarial balance, which the Social Security system would be in a position to begin repaying after 2072, on the assumption that new revenues had been raised and devoted to Social Security.

Without general revenues, Model 3 would be projected to cut Social Security's actuarial imbalance almost in half, from its current level of -1.86 percent of payroll to -0.99 percent of payroll. The provision for permanent dedicated general revenue transfer further reduces the actuarial imbalance, to -0.37 percent of taxable payroll. Finally, the provision for temporary general revenue transfers to ensure Social Security's liquidity throughout the 75-year valuation period is projected to bring the Social Security trust fund into long-term actuarial balance.

### *Improvement in System Solvency:*

Model 3 is projected to significantly improve Social Security's burden on the general fund of the U.S. Treasury by reducing the amount of general revenue required to finance benefit payments. Without reform, Social Security is expected to require over \$20 trillion of additional revenues (in 2001 dollars) to finance its benefit payments over the 75-year valuation period. Model 3 is projected to reduce the requirement by about 52 percent, or \$11 trillion (in 2001 dollars). The percent reduction in the burden is less, about 34 percent, when measured in present value terms. This is because the major portion of savings generated by the model's benefit growth restraint occurs during the latter half of the 75-year valuation period.

Model 3 includes a temporary transfer of general revenues to ensure that solvency is achieved and full benefits can be paid. Under current projections, these transfers would begin in 2034 and would continue until 2065. The largest transfers would occur during the years 2035-2040 and would peak at 2.5 percent of total taxable wages, or less than 1 percent of GDP. After 2040, the required transfers would decline quickly.

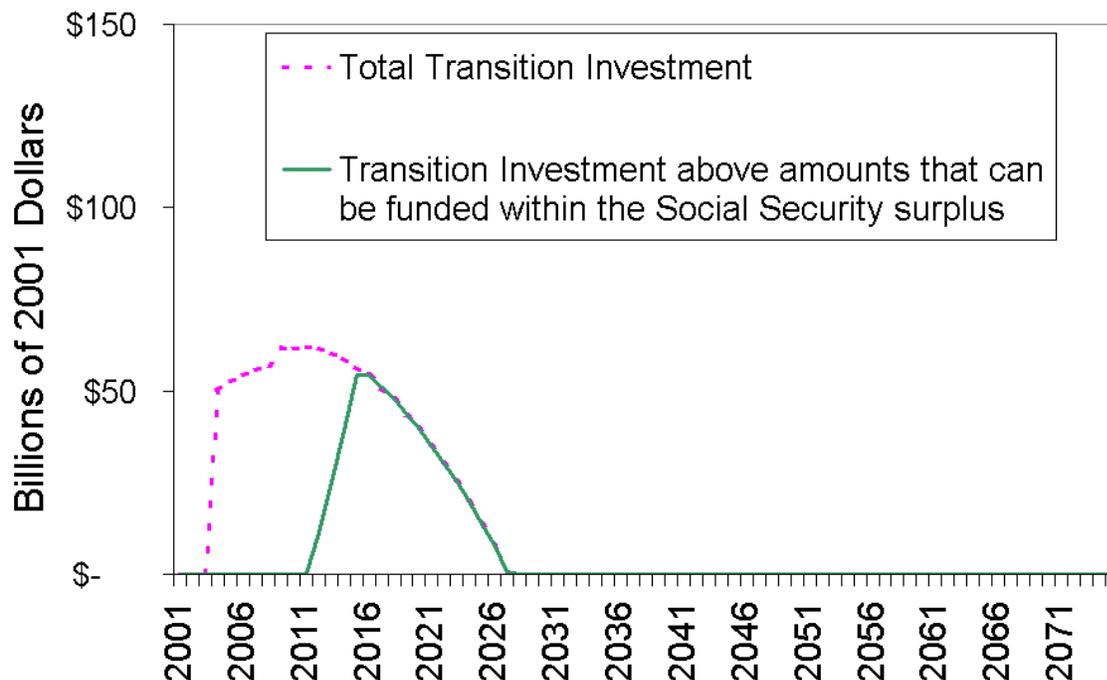
### Transition Financing

Reform Model 3 employs infusions of general revenues, with effects on the unified federal budget as described on the following page. Beyond these infusions, no new “transition” cash would be needed before 2012, assuming 67 percent participation, when the investment in personal accounts for the first time exceeds current-law surpluses. The “transition” financing requirements begin comparatively small – \$12 billion in real dollars 2012 – and would grow to a maximum of \$54 billion in real dollars in 2015-16. Thereafter the amount of new cash requirements for the new system would diminish, until in 2028, the new system would be no longer requires additional temporary transition financing. The system, however, would continue to rely on permanent infusions of general revenues throughout the valuation period, and the model’s net impact on the federal budget would turn positive in 2029, as shown on the following page.

In all, Reform Model 3 would require approximately \$400 billion (present-value) in total transition financing. Beyond that which would be available from projected Social Security cash surpluses under the plan, the figure would be approximately \$100 billion (in present value.)

Again, all of the figures above presume that only Social Security cash surpluses are available to provide transition financing. Were Congress to “lockbox” both cash and interest surpluses as previously intended, transition financing needs would be postponed by additional years.

### Reform Model 3 Transition Investment with 2/3 Participation



*Impact of Reform Model 3 on the Unified Federal Budget*

Assuming 67 percent participation, Reform Model 3 would have a net positive impact on federal cash operations by 2029, reaching \$558 billion (in 2001 dollars) by 2075. The largest negative impacts on the federal budget would be \$67 Billion in 2011-2012.

### Advantages of Model 3:

- Workers who opt for PRAs can reasonably expect to receive total Social Security benefits (including their PRA) exceeding current law promised benefits. Workers who do not opt for the PRA will receive larger benefits than are affordable under the present system.
- Revenues to the Social Security system are enhanced, in order to maintain current replacement rates (ratio of average benefits to average wages) for those who opt to participate in the accounts.
- The primary source of additional revenue is a voluntary 1 percent add-on to the new PRAs, subsidized by a progressive refundable tax credit. The add-on is matched by a redirection of part of the payroll tax—2.5 percent up to an annual maximum of \$1000 (indexed annually to wage growth) -- to the PRA.
- The add-on directly increases household saving and national saving, to the extent that add-on contributions do not displace other pre-existing saving. If saving increases, productivity and output would be increased.
- Some permanent transfers of new revenues are added from dedicated sources to the pay-as-you-go Social Security system.
- Intergenerational equity is maintained by holding constant the present value of lifetime benefits from Social Security as longevity increases.
- Work incentives are augmented by rewarding delayed retirement and by steeper actuarial penalties for early retirement.
- The obligations of future generations to pay unfunded obligations are dramatically reduced.
- The transition burden is kept manageable by the fact that some of the PRA comes from an add-on and by charging a 2.5 percent offset interest rate.
- Progressivity is enhanced and poverty reduced: The pay-as-you-go benefit is “flattened out” for higher earners, a new minimum benefit increases pensions of low earners and a higher survivors benefit helps alleviate poverty among the very old.

## ***The Role of Guarantees***

Finding: The Commission has chosen not to include guarantees in any of the three plans presented here. Advocates of guarantees in a voluntary personal accounts retirement system should carefully assess both the costs and the benefits of any such guarantee to holders of personal accounts, taxpayers, and retirement security over the long term.

Every public and private retirement system must continually balance the risks and rewards of alternative approaches to structuring and financing benefits for retirees. For example, unfunded systems, including the current U.S. Social Security system, are sensitive to demographic change, economic fluctuations, and political risk. The aging of the population and the declining ratio of workers to retirees places fiscal pressure on unfunded systems, leading to the risk to beneficiaries that benefits may be reduced in order to balance system finances.

Personal accounts holding real financial assets reduce the risk that participants face under an unfunded Social Security system. Personal accounts are owned by workers, and they provide an opportunity to diversify pension investments. However, investing in capital markets may expose participants to fluctuations in the value of their pension assets.

Concern about market volatility has prompted some analysts and policy makers to explore the possibility of “guarantees” of pension accumulations. In many cases, the desire for a “guarantee” is premised on the mistaken notion that the current Social Security system provides a guaranteed benefit. This is untrue. While the defined benefit formula does not subject individuals to financial market uncertainty, the formula itself can be changed and has been changed in the US numerous times in the past. This political risk to benefits is all the more real because the Social Security system faces perpetual financing deficits starting in the middle of the next decade, such that currently scheduled benefits cannot be paid.

With personal accounts, the simplest way for individuals to protect their retirement accumulations is to select low volatility investments in their portfolio. For example, an extremely risk averse individual will have the opportunity to invest in a conservative portfolio of bonds if he or she wishes. In fact, one of the great advantages of personal accounts is that individuals have the freedom to choose a portfolio that is best suited to their individual preferences over risk and return.

There are also other forms of personal account guarantees that policymakers could include in a reformed system. One approach promises that participants would receive no less than their lifetime contributions to the personal account, also known as a “principal guarantee”. This type of format was recently adopted in Germany and Japan, where retiring plan members must at least be paid back their contributions at retirement. Depending on the exact format of a principal guarantee, it might be relatively inexpensive to provide. Another guarantee could promise that a retiree would receive

his or her contributions plus the rate of inflation at retirement. As long as assets such as inflation-indexed bonds were available to back these promises, it is clear that such promises could be met relatively inexpensively.

A different form of guarantee might promise participants they will receive their contributions plus some minimum rate of return. For example, the design might promise participants that they will receive their contributions plus a return on government bonds (e.g., the returns on a 10-year Treasury bond index fund).

Alternative forms of guarantees might be structured such as a return on a corporate or diversified index bond fund. Some would argue that such a guarantee would be inexpensive inasmuch as US stock returns have historically been higher than bond returns. That is, over the past century, long-term investors in the United States have consistently earned a higher rate of return on a stock market index than they would have earned on a bond market index. Nevertheless, stocks are more volatile than bonds, so a guarantee would still have some cost.

Providing a guarantee of this sort is clearly valuable to plan participants, since investors receive a floor of protection against the chance of a market loss. These benefits derive from risk-sharing across cohorts and eliminating negative outcomes for particular cohorts. However, it follows that more valuable guarantees must also represent a larger liability to the sponsoring entity, be it a private sector group (such as a plan sponsor, insurer, or financial services firm), or a government entity. Over the last decade, the Congressional Budget Office (CBO) and the General Accounting Office (GAO) have both taken the position that government guarantees should be evaluated and their budgetary impact made clear. If a pension guarantee were to be included in a Personal Account plan proposal, it is necessary to estimate and recognize the financial cost of such a proposal.

The Commission agrees that both the benefits and costs of any explicit guarantee must be clearly identified in all proposals, whether or not these costs would be explicitly charged to participants in the Social Security program. Modern finance theory provides a number of option pricing modes that can be used to compute the “price” of a financial guarantee. This cost will depend on the amount that a worker contributes over his lifetime, the portfolio in which the assets are invested, and the nature of the guarantee benchmark. For example, the value and the price of a guarantee will be higher for portfolios that are more heavily weighted towards equities.

There are also several ways that Personal Account guarantees could be paid for. One option would be for private companies to offer participants the option to elect a self-financed guaranteed investment account. The financial services provider might offer a “guaranteed return account” as one investment choice people could elect in their accumulation portfolios if they were willing to pay a “guarantee premium.” In this case, people who desired a guaranteed investment product would pay a premium reflective of the value of the guarantee. There is also the concept of “financial collars,” where individuals give up some portion of their upside returns to the provider in exchange for

protection from downside returns below an agreed-upon level. Personal accounts are likely to spawn new financial products to fit the needs of each individual.

Alternatively, the cost of guarantees might be passed on to future taxpayers. In essence, this approach finances the guarantee through borrowing or future taxes “as needed,” i.e., whenever the revenue is required to fulfill the guarantee. This approach imposes an unfunded obligation on future generations, which reverses some of the salutary aspects of advance funding through personal accounts.

If guarantee costs were passed on to future taxpayers, instead of having participants self-finance them, it would mean that future taxes would be needed when guarantees were “in the money.” One concern is that the guarantor may be asked to pay out precisely when economic conditions times are bleak. Then taxpayers might be unable or unwilling to raise taxes on themselves to cover the guarantees, even if promises had been made in the past.

## ***The Role of Supplemental Security Income In Social Security Reform***

Several of the Social Security reform plans described in this report include minimum benefit provisions designed to ensure that lifetime low-earning workers may still count on a Social Security defined benefit that will keep them out of poverty. The current Social Security system does not provide this protection.

In addition, Commission members remain concerned that some people may reach old age without having worked in paid employment over their lifetimes. They might have engaged in unpaid work such as child rearing, or they may have experienced illness or other life events preventing them from engaging in paid employment for many years. Social Security does provide some protection through spousal benefits, survivor benefits, and benefits for disabled workers and their families. Nevertheless, because it is an earnings-based program, Social Security was not designed to provide universal income protection for every conceivable set of life circumstances. It is the judgment of the Commission that this role should be handled by a revised and updated Supplemental Security Income (SSI) program.

Enacted in 1972, SSI today is a means-tested income assistance program that provides monthly cash payments to needy aged, blind and disabled persons, in accordance with uniform, nationwide, eligibility requirements. Congress conceived of SSI as a guaranteed minimum income to supplement Social Security. SSI provides a safety net for those who reach old age with little or no Social Security entitlement. The maximum federal SSI benefit for individuals is \$531 in 2001. This is equivalent to about three-quarters of the elderly individual poverty threshold.<sup>46</sup> States supplement the maximum federal benefit to varying degrees. The average payment across all states was \$110 in 1999. SSI recipients are also generally eligible for Medicaid and are also eligible for food stamps. Total federal benefit outlays for SSI in fiscal year 2001 were \$28 billion.

A fully thought-out plan for reforming Social Security would do well to take account of how the defined benefit and personal retirement account components of Social Security interact with SSI. This Commission believes that changes in the SSI program should be devised to create a more cohesive retirement income security system, one that achieves an optimal balance of rewarding work, promoting individual saving, and providing an adequate retirement income safety net. It is the position of this Commission that a comprehensive retirement security system should provide improved poverty protection for the aged, either through SSI or some combination of Social Security and SSI.

This Commission recommends that Social Security reform plans should also encompass reforms in SSI policy, to improve retirement incomes for those persons who might not otherwise attain poverty-level income in old age. While the Commission did not have sufficient time to review the SSI program in detail, members believe that SSI program parameters should be re-examined to ensure that these provisions remain

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<sup>46</sup> Couples in which both members are eligible for SSI receive a maximum federal benefit equivalent to about 90 percent of the elderly couple poverty threshold.

consistent both with the original objectives of the SSI program and with the objectives of a reformed Social Security system. Under a Social Security reform plan that involves personal retirement accounts, it would be necessary to examine whether these income and resource limits of SSI remain appropriate.

## ***Treatment Of Disability Insurance In Social Security Reform***

The primary objective of this Commission has been to reform the Social Security retirement program. Although the Disability Insurance (DI) program faces financial problems similar to the Old-Age and Survivors Insurance (OASI) program, the nature of the issues facing the DI program are far more complex. As a practical matter, determining whether an individual is disabled for DI purposes is often a complicated and subjective process. Moreover, some basic features of the DI program are at odds with current thinking on disability policy, which emphasizes the importance of supporting disabled individuals' efforts to be self-sufficient when possible. The Commission's short life span has not allowed time for the careful deliberation necessary to develop sound reform plans for the disability program. Because of the complexity and sensitivity of the issues involved, we recommend that the President address the DI program through a separate policy development process.

The Commission recognizes the close integration between the DI and OASI programs. At the same time, changes in Social Security's defined benefit structure and the role of personal accounts may have different implications for DI and OASI beneficiaries. DI beneficiaries may not have their full adult lives in which to accumulate a retirement account, so this is a rationale for maintaining their traditional benefits. However, if benefits were changed for OASI but not DI, this might lead to an increase in DI applicants. The Commission urges the Congress to consider the full range of options available for addressing these concerns. In the absence of fully developed proposals, the calculations carried out for the Commission and included in this report assume that defined benefits will be changed in similar ways for the two programs. *This should not be taken as a Commission recommendation for policy implementation.*

In lieu of specific DI policy recommendations, this Commission has applied changes in defined benefits to DI recipients as well as OASI recipients in the reform plans presented in this report. This action recognizes the close integration between the two programs and is consistent with the historical relationship between DI and OASI defined benefits. Nevertheless, the Commission recognizes that changes in Social Security's defined benefit structure and the role of personal accounts may have different implications for DI and OASI beneficiaries. The Commission urges the Congress to consider the full range of options available for addressing these implications.

The DI and OASI programs are closely linked because they serve a unified purpose: to provide protection against the loss of earnings due to retirement, death, or disability. As such, the Primary Insurance Amount formula used to calculate benefits is the same for both programs. These two programs are also linked in that their finances are affected in similar ways by demographic changes. The Baby Boom generation is entering the age brackets that experience relatively high rates of disability. As a result, DI program outlays are projected to increase as a percent of payroll by 45 percent over the next 15 years, and DI costs will exceed DI tax revenue starting in 2009.

Nevertheless, a reformed Social Security system must take into account the fact that a planned retirement is a very different life event from an unplanned onset of disability. Personal retirement accounts are intended to partially replace the defined benefit component in Social Security. DI beneficiaries with abbreviated work histories might have relatively low account balances. Some may argue that this justifies isolating the DI defined benefit structure from any changes that would affect OASI defined benefits. On the other hand, testimony provided to the Commission indicated that many DI beneficiaries feel strongly that a parallel program structure should be maintained across both DI and OASI. Also, if the gap between OASI and DI benefits payable at a given age were to become large, incentives would increase for workers nearing retirement to seek to qualify for DI as a way to maximize income. This would put further pressure on DI program finances and could also raise equity concerns, if DI beneficiaries were able to receive higher total Social Security income than OASI beneficiaries. Further analysis is needed to determine the optimal approach to balancing these adequacy and equity concerns.

While both OASI and DI face financial shortfalls due to demographic changes, other factors affect the DI program that are more complex and may require a unique set of solutions. It has been decades since a comprehensive review of the DI program has occurred. There are indications that the standards used to determine disability vary across geographic regions and across different levels of the adjudicative process, which raises questions about the overall consistency and fairness of the program for claimants. In addition, fundamental questions exist as to whether the program adequately reflects Congressional intent and current thinking on disability policy. Technology, the economy, and social attitudes about disability have changed dramatically in the past 50 years. The law has only begun to respond to these changes. In 1999, for example, Congress passed the Ticket to Work and Work Incentives Improvement Act, a bill that provides improved access to return-to-work services for disabled beneficiaries and expands access to federally funded medical care for a period of time after they return to work. The philosophy behind this law is that some disabled beneficiaries can work and want to work, but they are discouraged from doing so because they lack access to rehabilitative services and medical care. While this law was a step in the right direction, further analysis is necessary to determine what more could be done to help DI applicants and beneficiaries who want to remain in, or return to, the workforce.

### ***Additional Savings Incentives***

The Commission believes that retirement security is best achieved through a combination of Social Security, work-based pensions, and personal savings. For many working individuals, however, work-based pensions are not available. For others (often the same workers), annual income earned is insufficient to allow much, if any, personal saving. For those earners, the Commission recommends enactment of additional savings incentives, especially policies targeted to younger workers and low-income workers.

## ***Participation from Outside Parties***

A Federal Register notice invited testimony from the public at the Commission's public hearings. We requested that witnesses present their views for modernizing and restoring fiscal sustainability to the Social Security program. Overall, the Commission held seven public meetings and heard testimony from more than thirty witnesses. The Commission thanks all those who presented constructive suggestions for the Commission's consideration.

The Commission also notes that several witnesses who were especially critical of personal retirement accounts were specifically asked to offer alternative plans. The Commission offered to have Social Security's actuaries score the plans so that we could fairly compare them with the other constructive suggestions received. The Commission regrets that it has not yet received plans from some witnesses who offered to provide them.

## ***Acknowledgements***

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The Executive Director of the Commission, Chuck Blahous, wishes to thank each of the sixteen members of the President's Commission to Strengthen Social Security, for their tireless work, for their integrity, and for their dedication to fulfilling the charge put forth in the President's Executive Order. He would like to extend special thanks to the following staff members whose efforts were crucial to the completion of this project:

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