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Strengthening Social Security and Creating Personal Wealth for All Americans

Report of the President's Commission

December 11, 2001

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 <u>insurance</u> 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 <u>minus</u> 0.72 percent.[1]

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.

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[1]. OACT/SSA projections, May 27, 2001, Table 9.

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 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.

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 such a 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.

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.[2]

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 study by the State Street Bank entitled, "Administrative Challenges

[2]. Congressional Budget Office, "Effective Federal Tax Rates, 1979-1997," October, 2001, p. xxi.

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. We, the co-chairs, note here that it would be straightforward for the government to set up such accounts. 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.[3] 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.

<u>Carpe diem!</u>

Daniel Patrick Moynihan, Richard D. Parsons
Co-Chairs

December 11, 2001

[3] Today, a scaled medium earner earns $35,277 annually.

Findings:
The Commission agrees that 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, and 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 legitimate 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 involving personal accounts. 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 (inflation adjusted).

- 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 <u>significantly increasing benefits for low-income workers above what the system currently pays</u>. 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. All three require a transition investment from general revenues to strengthen Social Security, but all three reduce the long-term need for general revenue as compared to the current, unsustainable, system. In all three plans, 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 Members of Congress and to the American public in order to enrich national understanding of the opportunities for moving forward.

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:

- Currently scheduled benefits from the existing system, which cannot be paid by existing payroll tax revenues ("scheduled benefits").
- Benefits that are payable given in the existing tax revenues ("payable benefits").
- Benefits currently paid to retirees ("currently paid benefits").

All of these benchmarks are legitimate, but they are significantly different. For example, comparing benefits under a reform plan to "promised benefits" is an unfair comparison because currently promised benefits are not payable. Without adding more revenue to the system, a more appropriate comparison would be 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 redirect 2% of their payroll taxes to 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% above inflation.
- No other changes are made to traditional Social Security.
- Expected benefits to workers rise while cash deficit of Social Security falls at end of valuation period.
- Workers, retirees and taxpayers continue to face uncertainty because a large financing gap remains that requires future benefit cuts or substantial new revenues.
- Additional revenues are needed to keep the trust fund solvent starting in mid-2030's.

Reform Model 2 enables all future retirees to receive a Social Security benefit that is 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 it balances Social Security revenues and costs.

- Workers can voluntarily redirect 4% of their payroll taxes up to $1000 (wage indexed) to a personal account.
- No additional contribution from the worker would be required.
- 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, since additional protections against poverty are provided for low-income workers and survivors.

- Expected benefits payable to a medium earner electing a retirement account would be 59% 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.
- Solvency will be achieved by price indexing instead of wage indexing initial benefits, beginning in 2009.
- Temporary transfers from general revenue would be needed to keep the Trust Fund solvent from 2025-2054. Furthermore, this model achieves a positive system cash flow during the 75-year valuation period under all participation rates.

<u>Reform Model 3 establishes a voluntary personal account option that enables workers to reach or exceed current-law scheduled benefits and wage replacement ratios, by adding new sources of revenue and by slowing benefit growth less than price indexing.</u>

- Workers who opt for personal accounts can reasonably expect to receive total social security benefits (including their PRA) that exceed scheduled benefit levels and current replacement rates.
- Personal accounts are created by a match of part of the payroll tax – 2.5% up to $1000 annually – for any worker who contributes an additional 1% of wages subject to Social Security payroll taxes.
- The add-on is partially subsidized for workers in a progressive manner by a refundable tax credit (33% up to a $100 maximum).
- Solvency is restored to the traditional social security system by:
  - ♦ adjusting the growth rate in benefits for actual future changes in life expectancy,
  - ♦ increasing work incentive by decreasing the benefits for early retirement and increasing the benefits for late retirement, and
  - ♦ flattening out the benefit formula (reducing the third factor from 15 to 10%).
- New sources of dedicated revenue are added.
- Transition burden is reduced by charging a 2.5% benefit offset, making additional contributions to the personal account.
- Progressivity is enhanced and poverty reduced by providing a minimum benefit for low earners and an improved survivors' benefit.
- Additional temporary transfers from general revenues are needed to keep the trust fund solvent from 2028-2057.

Specifications of Commission Reform Models

	Model 1	Model 2	Model 3
PERSONAL ACCOUNTS			
Personal Account Size	2%	4% up to $1000 ($1000 is wage indexed)	1% new contribution plus 2.5% up to $1000 ($1000 is wage indexed)
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	Yes	Yes	Yes

heirs?			
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
TRADITIONAL SOCIAL SECURITY BENEFITS			
New minimum benefit	None	By 2018, a 30-year minimum wage worker is guaranteed benefit = 120% of poverty level, inflation indexed.	By 2018, a 30-year minimum wage worker is guaranteed benefit = 100% of poverty level, then rising.
Widow/Widower Benefits	No changes	Increase to 75% of couple benefits (vs. 50% to 66% today) for lower wage couples	Increase to 75% of couple benefits (vs. 50% to 66% 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	1. Reduce benefit for early retirement and increase benefit for late retirement. 2. Gradually

			decrease bend point factor for highest income bend point from 15% to 10% starting in 2009

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.

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

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.

Advance funding within Social Security can best be accomplished through personal accounts rather than direct government investment in the stock market.

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, relative to their absence, for reasons outlined on the following pages.

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 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.[4]

- 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.[5]

- Individuals with investment assets, and their children, perform better on educational tests and reach higher educational attainment, even after accounting for income.[6]

- Single mothers and their children are less likely to live in poverty if the mother came from a family with asset holdings, again even after controlling for education and socio-economic status.[7]

- 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.[8]

- 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.[9]

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.[10]

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

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[4] Galligan & Bahr (1978); Hampton (1982); South & Spitze (1986)
[5] Moore et al. (2001)
[6] Mayer (1997), (Hill and Duncan, 1987).
[7] Cheng (1995)
[8] Pritchard, Myers & Cassidy (1989)
[9] Moore et al., 2001.
[10] "The Impact Of The Shift To Defined Contribution Plans On Bequests And Living Standards In Retirement," Alicia H. Munnell, Mauricio Soto, Annika Sundén, and Catherine Taylor, 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

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."[11]

"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.

[11] 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.[12]

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 can 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 choose to take a personal account, but that when the choice came, more than two-thirds actually opted for them. One reason, Schwartz said, is that many people feel more secure with an asset than with an entitlement: an account that is their own property is perceived to be safer than an untenable government promise to be fulfilled decades in the future.

[12] Social Security Administration website; http://www.ssa.gov/history/nestor.html

Retirement security is also enhanced by diversification of risk. The creation of personal accounts would diversify the risk inherent in the Social Security system by allowing individuals to split risks 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 can choose the combination of risk and return to which his age 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 the possibilities 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.

African Americans Hold Substantially Less Wealth At Retirement

	Total Net Worth		**Financial Assets**	
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 relative to men, single individuals relative to married couples, 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 promises 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[13] during that period, with a corresponding deterioration in Social Security's equitable treatment of different generations.

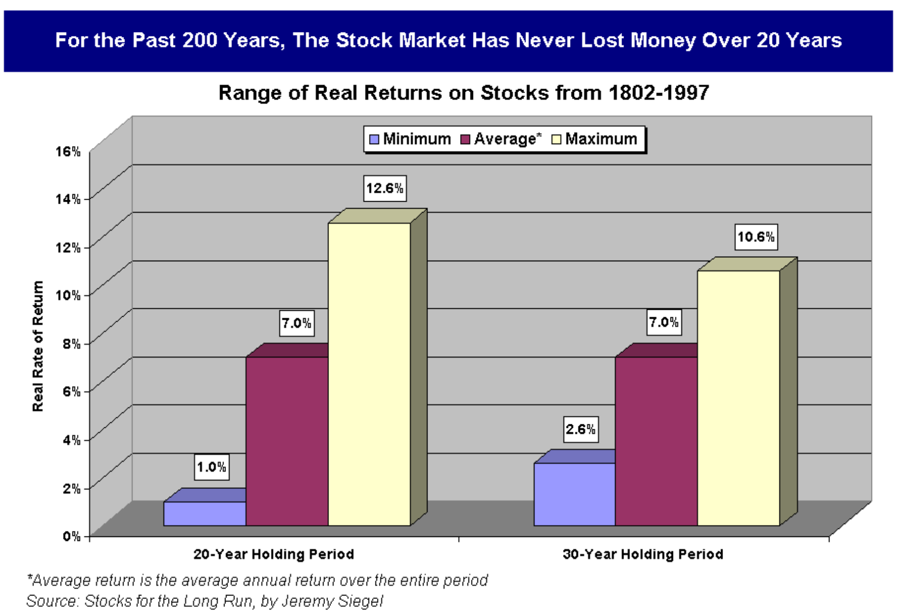
To ensure that Social Security's financing burdens are equitably shared, it is imperative that a portion of these revenues be devoted to advance funding. The resulting increase in national saving will raise the country's capital stock, and therefore boost our productivity and output. In essence, increased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

[13] 2001 TR page 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 diversion to 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 only be provided 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.



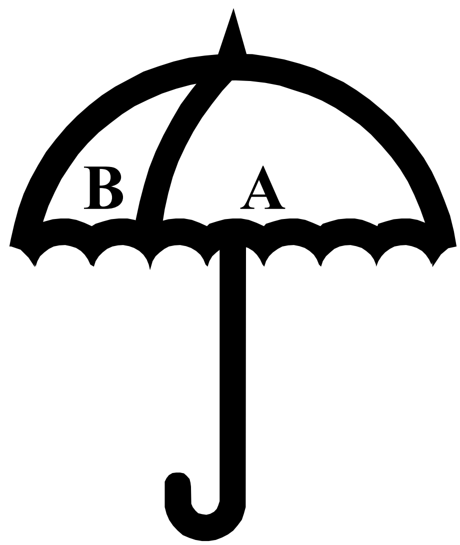
Going forward, the nation faces a range of choices to bring the existing Social Security system to a path of fiscal sustainability. For purposes of illustration, In Chapter 4, the Commission shows the effects of one approach to balancing the Social Security system without tapping additional tax revenues, 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 would derive in turn from an individual's opportunity to realize the gains that come from returns on capital. Over a working lifetime, 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.

Tomorrow, 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 in the stock market.

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, this is likely to limit the diversion of these assets 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.[14] 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 retirement decision. Research suggests that workers do not fully understand the complex linkage between the taxes they pay and the benefits they receive.[15] 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.[16] These distortions are a drain on the nation's economy, reducing output and growth, and make 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.[17] 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

[14] Peter Diamond and 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 <u>Themes in the Economics of Aging</u> 2001.

[15] 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

[16] Martin Feldstein & Jeffrey Liebman "Social Security" NBER WP 8451, forthcoming in <u>Handbook of Public Economics</u>

[17] 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 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.

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.

The 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 are also now in the process of creating personal accounts, including Russia and China. Even Sweden – the country traditionally offering a large amount of publicly provided welfare – has also recently added personal accounts to their public pension program. Experience in the United States with 401(k) plans and Individual Retirement Arrangements[18] have 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 21st 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.

[18] Individual Retirement Arrangements (IRAs) are also commonly referred to as "Individual 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, which should be achieved to the extent possible through competition among managers. 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 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 the services that they are receiving from the central administrator 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. The importance of choice is accentuated by the fact that the central administrator in a Social Security system augmented with personal accounts would be required to interact with businesses of many sizes as well as with self-employed individuals. A centralized "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 on 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. Initially, investments for each employee are made through the central administrator (as in the centralized plan) 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 move their personal accounts to 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.[19] 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 three years from the creation of personal accounts, the Governing Board must produce a plan that is necessary for Tier II to be fully functional; within five years, it must implement the rules and administrative support, including personnel, hardware and software.

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, along with information provided by the Governing Board, will keep fees low and in proportion to services received. 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.

[19] 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,[20] 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.[21] 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.[22] 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.[23] 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.[24]

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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[20] 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.

[21] 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).

[22] 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.

[23] 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.

[24] 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.[25]

[25] 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.[26] 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.[27] 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.

[26] 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 with readily available price data).

[27] 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.[28] 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.

[28] 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 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.

Upon reaching a threshold amount in their personal accounts in Tier I, participants can transfer their personal account to a private-sector provider. Private-sector funds, therefore, provide competition and choice, thereby preventing a government monopoly over fund design and services. 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. (For example, the commission recommends that disability protection continue to be provided through the traditional Social Security system.) 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 love ones 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 to us.

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.[29] 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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[29] 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 using investments as social policy. Evidence indicates that these pension plans have earned markedly inferior rates of return, due to government intervention.[30]

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[30] Augusto Iglesias and Robert Palacios, "Managing Public Pension Reserves – Part I: Evidence from the International Experience," Pension Reform Primer, The World Bank, January 2000.

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 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 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 may be the single most 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 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 simplest 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.[31] 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 real economic resources, 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

[31] 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 "fall off the cliff."

A fourth disadvantage is that the concept 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. Actuarial Balance Not Deteriorating at the End of Valuation Period:
The actuarial balance measure just described can have a “cliff effect,“ which 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 is a measure of the balance of the OASDI Trust Fund relative to the level of benefits being paid out in the same year. A stable or rising Trust Fund ratio indicates that the actuarial balance is not deteriorating.

6. Reduction in Unfunded Benefit Obligations:
As previously discussed, the current Social Security system is primarily an unfunded system. This means that individuals paying into the system now are expecting benefits in the future, yet there are no resources set aside today to pay those future benefits, as would be the case in a funded system such as a private pension plan

In the private defined benefit pension context, a plan sponsor must by law project future plan costs and revenues, and sufficient assets must be set aside to cover promised benefits. Under a “closed system” approach, the plan sponsor would assume that no future additional contributions would be made and no new benefit promises would be honored after the valuation date. Under an “open system” approach, the plan sponsor would assume that new contributions would come in, and new benefits would be accrued, into the indefinite future. Pension law (ERISA) requires that the “closed system” concept be used to fund asset reserve requirements for corporate pensions.

By the 75-Year Open Group method, OASDI is currently under-funded by about $3.157 trillion (or about $21,000 per worker). According to the 100-Year Closed-Group method it is now under-funded by about $9.6 trillion (or about $65,000 per worker).[32]

An important measure of the contribution of a reform proposal to the health of the economy is the extent to which a reform reduces the size of this unfunded liability. This approach recognizes the contribution to our nation’s long-term economic well-being that is missed by standard actuarial measures. The primary limitation of this approach is that it is not yet well understood by the general public.

7. Other Measures
Some analysts have argued that it would be more complete to measure each generation’s total financial burden of taxes and transfers levied on it, including Social Security and other liabilities not currently tracked on budget. From this perspective, a reduction in generational net burden would be seen as an improvement in fiscal sustainability.

This approach offsets the political bias against pre-funding future implicit liabilities. Reducing implicit future liabilities now, in part through explicit debt finance, may be

[32] April 5, 2001 calculations by the Office of the Chief Actuary, Social Security Administration.

interpreted as a growth in public debt, so that little “credit” is granted for curtailing the total stock of unfunded liabilities including OASDI. Measuring the generational burden in the government budget would reduce this bias and give policymakers a tool for assessing decisions that involve trade-offs between short-term costs and long term benefits, and between implicit and explicit debt.

The primary disadvantage of this concept is that it is not well understood in policy circles. In addition, implementing it requires assumptions regarding who bears the costs and benefits of government taxes and transfers, as well as social discount rates, and there is little agreement about the proper range for these assumptions. Therefore, the Commission will not explicitly provide these measures for the reform options discussed in this report.

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 of investing a portion of their payroll taxes in accounts that they own. Like any sound investment program, investing in personal accounts requires additional resources up front to fund the accounts. 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, there exist additional revenues to finance the accounts.

Therefore, funds must temporarily be found to finance this investment while simultaneously paying benefits to retirees. Over time, these investments in personal accounts offer financial returns to the Social Security program in the form of either reductions in the rate of growth of system costs, higher expected benefits for retirees, 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, which is faster than the growth of the total economy, 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.[33] 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 initial benefits coupled with future demographic trends have never been fiscally sustainable.

[33] 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, 94th Congress 2nd 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 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: Personal Accounts and Social Security Reform

Findings: 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.

Reform Models

Objectives

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.

Personal Accounts – the Unifying Element

The Commission has developed three alternative models for Social Security reform involving personal accounts. Individually and as a group, they illustrate how personal accounts can be a component of any legislated program to strengthen Social Security.

To bring the Social Security system to a path of fiscal sustainability, there are two choices. On the one hand, significant tax increases might be required in order to pay for benefit growth promised, but not payable, under current formulas. On the other hand, benefit growth could be restrained to make benefits payable under projected program revenues. The Commission believes that no matter which approach is taken, personal accounts can enhance benefits expected by participants in the Social Security system. Analysis of the reform models described here illustrates the significant gains for workers anticipated from personal accounts.

Understanding the Three Reform Models

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

<u>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</u>.

Under this approach, workers could voluntarily direct 2 percent of their payroll taxes to a personal account. In exchange, traditional Social Security benefits would be offset by the worker's personal account contributions compounded at a real interest rate of 3.5 percent. No other change would be effected in Social Security rules, meaning that as-yet unspecified actions would be required to avert insolvency. In this model, personal accounts would boost expected benefits for workers who elect them while also making a modest contribution to long-term system sustainability as measured by reduced cash deficits in the last years of the valuation period. Expected benefits payable to a medium earner electing an account would be nearly 31 percent above benefits currently paid to today's retirees by 2052. At the end of the valuation period, the personal account system would hold $1.65 trillion (in today's dollars), much of which would be new saving. However, workers and retirees would still face considerable uncertainty because filling the remaining financing gap would require substantial general revenue. Substantial additional revenues would be needed to keep the Trust Fund solvent beginning in the mid-2030s, assuming no legislated changes to Social Security benefit formulas.

<u>Reform Model 2 establishes a voluntary personal account while maximizing the benefits delivered without raising taxes or requiring additional worker contributions, and while balancing Social Security revenues and costs</u>.

Under this approach, workers could voluntarily contribute 4 percent of their payroll taxes up to $1,000 annually to their personal accounts (the contribution cap would be indexed annually for wage growth). In exchange for this, traditional Social Security benefits would be offset by the worker's personal account contributions compounded at a real interest rate of 2 percent. In this model, all workers choosing personal accounts could expect total benefits higher than those payable by the traditional system. The plan is progressive, since additional protections against poverty are provided for low-income workers and survivors. This progressivity is brought about by increasing traditional Social Security benefit amounts for everyone at the level of increases in the cost of living over time. Expected benefits payable to a medium earner electing an account would be 59% above benefits currently paid to today's retirees by 2052. At the end of the 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. Some temporary transfers from general revenue would be needed to keep the Trust Fund solvent from 2025-2054. Furthermore, this model achieves a positive system cash flow during the valuation period under all participation rates.

<u>Reform Model 3 illustrates how the Social Security system could be brought to financial sustainability while maintaining currently scheduled benefits and existing wage replacement ratios.</u>

Under this model, actions taken to balance the traditional Social Security system would be a combination of changes in the rate of benefit growth and commitments to new revenue sources. Specifically, the growth rate of benefits would be linked to the increasing life span of Americans while allowing workers to continue to choose when to retire. Workers would have the opportunity to receive a match of 2.5 percent (up to $1,000 annually) of their payroll taxes if they chose to contribute an additional 1 percent of their payroll base (a contribution that would be subsidized by a refundable tax credit). In addition, Model 3 envisages new sources of tax revenue dedicated to Social Security. These extra contributions and new revenue sources would allow participating workers to receive expected benefits exceeding those available under the current system and to maintain current replacement ratios of benefits to wages.

The plan is progressive, since additional protections against poverty are provided for low-income workers and survivors. This is accomplished by adapting the traditional

Social Security benefit formula in several ways, including providing a higher benefit for below-average income widows, reducing the benefit formula for high wage earners, and adding a minimum benefit for low wage earners. Expected benefits payable to a medium earner electing an account under this plan would be 88 percent above benefits currently paid to today's retirees by 2052. At the end of the valuation period, the personal account system would hold $2.4 trillion (in today's dollars), the result of new saving as well as the added worker contribution. Additional temporary transfers from general revenue would be needed to keep the Trust Fund solvent from 2028-2057.

The President's Principles
All of the models proposed meet the President's principles.

- *Modernization must not change Social Security benefits for retirees or near-retirees.*

None of the models presented would in any way affect any individual over the age of 55. One model would not make any changes to Social Security's basic benefit structure.

- *The entire Social Security surplus must be dedicated to Social Security only.*

All models assume that all revenues dedicated to the Social Security program will ultimately be made available to fund Social Security benefits, and thus that the federal government will honor all obligations created by the Social Security surplus. Many observers are concerned about the disposition of Social Security surpluses at times when the federal government runs a deficit in its non-Social Security accounts. As the Commission noted in its Interim Report, it has not been the normal historical practice of the federal government to literally "save" surplus Social Security revenue. This surplus money, however, remains earmarked for Social Security, and all debt issued to the Social Security system must be honored by the federal government. Accordingly, the entire amount of the Social Security surplus is available either to issue debt to the Trust Fund or to fund Social Security benefits through personal accounts.

- *Social Security payroll taxes must not be increased.*

None of the models presented on the following pages would increase payroll tax rates or the payroll tax base.

- *Government must not invest Social Security funds in the stock market.*

None of the models presented on the following pages would allow for any investment of Social Security funds in the private markets except through individually-owned personal accounts. Confining such investment to individual ownership reduces the risks of political influence on private capital markets.

- *Modernization must preserve Social Security's disability and survivors components.*

The models presented here retain disability and survivors' protection under Social Security. Two of the models include a recommendation to increase survivors' benefits.

- *Modernization must include individually controlled, voluntary personal retirement accounts, which will augment the Social Security safety net.*

All the models give workers an option to invest in a personal account through the Social Security system. In each case, workers with personal accounts could expect higher total benefits than those remaining in the traditional system. Two of the models also make substantial improvements to Social Security's traditional benefit structure to strengthen the safety net against poverty.

Going Forward

The Commission finds that there are multiple paths to fiscal sustainability that are in keeping with the President's principles for Social Security reform. All three models include a personal account element that would permit participants to build substantial wealth, diversify their retirement portfolios, and expect to receive higher benefits than those paid to today's retirees. All three of the models improve fiscal sustainability, though some move farther than others.

We anticipate that our work will illustrate the key advantages of adding personal accounts to the set of options available for Social Security reform. Whatever choices are made, our leaders owe it to the American people to explain clearly the value that can be provided by personal accounts, the opportunities to use personal accounts to strengthen our system so it can actually pay benefits promised, and the realistic costs and benefits of these options. Critics of personal account reform models for Social Security must offer a comprehensive and fully scored alternative of their own to move the debate forward.

Building substantial wealth in personal accounts can be and should be a viable component of strengthening Social Security. We look forward to constructive suggestions and a reasoned public debate about the advantages of each approach.

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% 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% 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.[34] 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% 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.

[34] 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 in corporate and government bonds, and only 20 percent in equities. In this example, the variable annuity portfolio assumption would be equivalent to assuming an 80 percent bond, 20 percent equity portfolio.

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.

For this reason, all of the model reform plans contained here use a simple interest rate calculation for the personal account election. In exchange for a personal account, the individual gives up the amount of benefits that contributions to the account, plus interest, could have bought from the traditional Social Security system. For low earners, this method will result in a smaller offset than it will for high earners. The plans differ in terms of the interest rate that is used to calculate the offset. A lower interest rate for the offset means that the worker gets a higher net benefit but there is less progress in reducing costs for the traditional Social Security system. Under Reform Model 2, for example, the offset is calculated using a 2% interest rate, which means that an individual will receive higher total benefits if his account's return averages more than 2 percent after inflation.

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.

It is also highly important to recognize that this offset method is not, unlike many personal account proposals, a "clawback" mechanism. Many proposals to establish personal accounts would "claw back" proceeds from accounts to fund existing Social Security benefit promises. 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 interest rate charged on these contributions.

The Commission finds "clawbacks," in addition to other ex-post offsets, to carry some undesirable side effects, and thus has included no such proposals among its Reform Models. Significant among these is that an individual would be unable to assess the financial ramifications of a decision to invest in a personal account at the time the decision must be made.

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. This has the advantage of showing the extreme bounds of the possibilities that could arise.

In practice, however, participation will be somewhere between these extreme bounds of 0 percent and 100 percent. For that reason, the Commission has also included, in the appendix, projections that are premised on an assumption of participation by two-thirds of eligible individuals.

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.[35]

Measures of Fiscal Sustainability

Each Reform Model's fiscal effects will be evaluated according to "scorecards" that employ the measures of fiscal sustainability that are defined and appraised in Chapter 3.

Charts: Financial Operations of the Social Security System

[35] There are exceptions to these conventions in the report, which reflect the limitations on data available at the time the report was released.

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.

For each reform plan, annual cost and income rates will first be shown for the remaining pay-as-you-go system, excluding money that is invested in personal accounts. This reflects the Commission's view that individuals should retain ownership over the money invested in personal accounts, which ownership would never transfer to the government at any point. This treatment shows the investment in personal accounts as a reduction in government revenues, with the savings based on the investment resulting in lower outlay obligations

Additional charts will include the colletions for and flows into personal accounts. These charts are useful for two reasons: First, the total investment in the Social Security system depends in part on the amount of funding placed in personal accounts, which is not visible on charts that show only the operations of the traditional system. (For example, "add-on" contributions, to personal accounts, would not be visible as factors affecting income and cost rates under the first method of portrayal.) Secondly, this treatment follows the conventions of the Congressional Budget Office in scoring Social Security reform proposals.

Solving the Fiscal Problem: Reducing Future Cash Deficits

Under current law, the present value of Social Security's revenue imbalance is commonly said to be $3.4 trillion. This, however, is a net figure, counting past attributions to the Social Security Trust Fund, as well as projected surpluses, as revenue sources that offset the cost obligations that Social Security faces in the future.

Going forward, the net imbalance of the present value of Social Security's revenue intake and its outlay obligations over the next 75 years is $4.2 trillion. The total present value of its projected cash deficits over the next 75 years is $5.1 trillion. This is the true measure of the program's unfunded obligations, if indeed there is a failure to save near-term Social Security surpluses.

Measuring Transition Financing Under the Three Reform Models

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 requires that some consumption be foregone 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 these sections concerning “transition” financing.

In the near term, a transition to each of the following reform models can be financed from current-law Social Security surpluses.

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 securtiy developments, was intended to wall off both Social Security cash <u>*and*</u> *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.*

Benefit Projections

Expected benefits for each of the proposals are shown on the following pages. These projections employ the intermediate rate of return assumptions of the Social Security Office of the Actuary, assuming that account balances are converted to a variable annuity upon retirement. Further explication of these assumptions is provided on the following pages.

Comparisons will be made between the levels of benefits that can be provided through the personal accounts, and the levels that can be provided by the existing Social Security system.

Each of the frameworks presented here would allocate varying levels of revenue to the Social Security system. Thus, benefit levels are not directly comparable across the various frameworks. (Within Reform Model 1, for example, decisions remain as to the balance between benefit growth and allocations of additional revenues.) The level of revenue to be provided to Social Security over the next 75 years remains subject to legislative action.

Each framework, however, can and does show the benefit levels that would be provided for those who opted for the accounts in comparison with those who opted to stay in the traditional system. In no cases is a benefit "cuts" in real terms required, and all benefit levels will be higher than those received by today's retirees. In addition, projections are that individuals who choose personal accounts can expect to receive higher benefits than those opting to remain in the current system.

Perhaps most importantly, each set of projections shows that for a given level of revenue, benefits for a system of personal acc ounts would be higher than systems without them.

Each proposal shows the benefits provided under each personal account proposal, both in comparison to the current Social Security system within a given revenue stream, and in comparison to today's benefit levels.

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 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 they 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) an insolvent Social Security system (in which benefits will be precipitously reduced unless tax revenue is increased) 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.

Three Approaches to Strengthening Social Security

Personal Accounts – the Unifying Element

Congress and the President face a wide range of choices to bring the Social Security system to a path of fiscal sustainability. On the one hand, benefit growth for the traditional Social Security system could be set at a rate that can be funded within projected program revenues. On the other hand, significant new revenues would be required in order to fund the currently-scheduled pace of benefit growth.

The Commission has found that no matter which approach is taken, personal accounts will increase the expected benefits received by workers or decrease the cost to taxpayers. Analysis of each of the reform models described here demonstrates the significant gains for workers that would arise from personal accounts.

Understanding the Three Basic Approaches

The reform models presented here are intended to illustrate the basic choices involved in strengthening Social Security, both with and without personal accounts.

<u>Reform Model 1 shows the implications of establishing personal accounts without making any changes to Social Security's benefit and revenue structure</u>. Under this approach, the personal accounts would increase expected benefits for workers while making a small contribution to long-term sustainability. However, considerable uncertainty would remain for workers, because yet unspecified actions would be required in the future to permanently avert insolvency. In addition, the personal accounts themselves could offer smaller benefit increases than would be the case under a wholly balanced system.

<u>Reform Model 2 is illustrative of the choices facing the nation if it desired to balance the Social Security system and to maximize the benefits delivered without tax increases or additional worker contributions</u>. Basic Social Security benefits under this reform model would grow at the rate that the existing Social Security system can sustain. Specifically, initial benefit formulas would grow with inflation for most workers, and benefit growth above this rate would be targeted to create additional protections against poverty for low-income workers and widows. The personal accounts would be very attractive because they would provide all workers with the opportunity to significantly exceed the level of benefits that the traditional system can afford to provide. This model also allows for a direct comparison between the levels of benefits that can be provided from projected revenues, with and without personal accounts, because the traditional benefit structure under this model is what is affordable in the absence of personal accounts, on average over the 75-year actuarial period.

<u>Reform Model 3 has the objective of meeting or exceeding current-law benefit promises and maintaining wage replacement ratios, by adding revenues. It shows that the necessary revenues are smaller under a personal account system than they would be</u>

<u>for the current system.</u> Under this model, the traditional Social Security system is balanced through a combination of changes in the rate of benefit growth and commitments of new revenues. Workers would have the opportunity to redirect part of their payroll tax to a personal account if they also contribute an additional 1 percent of their pay to the account. This contribution would be subsidized through a partial and progressive refundable tax credit. This extra contribution enables the total expected benefit to grow at least as fast as wages and to equal or exceed the benefit level scheduled under the current system—but at much lower cost.

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. 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 from 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 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 interest earned 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 Changes to Traditional Social Security System

- Workers would be given the opportunity to invest 2 percent (or another percentage) of their taxable wages in a personal account.

- In exchange for the benefits provided by the accounts, participating workers would give up, in traditional Social Security benefits, the total value of their investments in the account, compounded at a 3.5% real interest rate.

Some have proposed creating personal accounts while making no changes either to the traditional Social Security system's benefit formula or to its dedicated revenue stream. Under this framework, further actions would eventually be required to bring Social Security to long-term sustainability. If no individuals elected to participate in personal accounts, the measures required would be exactly those necessitated under current law. If individuals participated in personal accounts, there would be a small improvement in the system's long-term sustainability.

This option would be relevant if Congress decided to act separately on the issues of creating personal accounts and restoring fiscal sustainability. In the particular example scored here, individuals would be given the opportunity to invest 2 percent of their taxable payroll 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. (One approach to this might 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.

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. This offset rate is higher than under Reform Models 2 and 3, reflecting the trade-off between the attractiveness of the account and the challenge of taking action to restore balance to the traditional system. Although the Commission projections show that individuals are likely to see increased benefits if they elect to participate in personal accounts, the gains will be more modest than under Reform Models 2 and 3.

Another variation on this framework would be to supplement traditional Social Security benefits with voluntary personal accounts, established and funded 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.

Implications of Reform Model 1:

- Reform Model 1 would permit policy makers to separate the issues of permanent fiscal sustainability and personal accounts. Specifically, it would provide policy makers 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.

- Total benefits under Model 1 would be higher than under the current system, to the extent that participants exceed a 3.5 percent real rate of return on their personal accounts.

- Under Model 1, further actions would be required 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.

- Model 1 is a flexible framework. It can be molded to fit the particular desires of policy makers with respect to such factors as the size of the accounts, and whether to establish a progressive funding mechanism for the accounts.

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

Scorecard for Reform Model 1

Model 1 is a flexible framework that is adaptable to various ways of financing the accounts. 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.

New Saving and Benefits due to Personal Accounts: 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 the current system. By 2017, more than $1 trillion (present value) are projected to have been accumulated in the personal accounts. This figure would surpass $2 trillion in 2035.

Positive Annual System Cash Flow Within Valuation Period: Reform Model 1 would not return to positive annual cash flow within the 75-year valuation period. Assuming 100 percent participation in personal accounts, cash deficits by the end of the valuation period would be reduced by 36 percent relative to current law. Under 67 percent participation, they would be reduced by 24 percent.

Improvement in System Solvency: Despite improving long-term fiscal pressures, Reform Model 1 would increase short-term revenue requirements to maintain Trust Fund liquidity. If structured as a 1 percent payroll tax contribution matched by a 1 percent contribution from general revenues, these additional revenue requirements to maintain Trust Fund liquidity would begin in 2023, assuming 100% participation. Assuming 67 percent participation, they would begin in 2026. (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” that is explained in the Methodology section.)

Reduce Rate of Growth in Long-Term System Costs as a Percent of GDP:
Assuming 100 percent participation in the accounts, total growth in system costs relative to GDP would be reduced by 30 percent through the end of the valuation period. Assuming 67 percent participaton, they would be reduced by 20 percent.

Improvements in 75-Year Actuarial Balance: If structured as a 1 percent payroll tax contribution matched by a 1 percent contribution from general revenues, the net actuarial imbalance, assuming 100% participation, would be approximately –1.34 percent of payroll over 75 years, an improvement of approximately 28 percent relative to current law. Assuming 67 percent participation, the improvement would be approximately 16 percent. If structured as a two percent contribution from payroll taxes, improvements in actuarial balance would occur only after the 75-year valuation period. 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 fiscal effects on beneficiaries and taxpayers. Either way, the total revenues required to achieve solvency would be exactly the same.

Actuarial Balance not Deteriorating at the End of Valuation Period:
Because this reform model does not attain 75-year solvency, there would be no positive actuarial balance at the end of the valuation period.

Reduction in Unfunded Benefit Obligations: At the end of 75 years, assuming 100 percent participation in accounts, future unfunded obligations of the Social Security system would be reduced by approximately $1.3 trillion (in present value) relative to current law. For 67 percent participation, the reduction in unfunded obligations would be approximately $891 billion.

Benefit Projections for Model 1

Expected benefits for Reform Model 1 would be higher than those in the traditional system, although the program's fiscal challenges would remain qualitatively similar to current law.

Expected benefit projections for Model 1 are more uncertain than for Models 2 and 3, because only under the latter Models is the program fiscally sustainable throughout the valuation period. 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, benefit projections for Model 1, both for individuals who take the accounts and for those who do not, are subject to continued uncertainty. If all individuals opted to stay in the traditional Social Security system, full benefit promises would be met as scheduled through 2038, and then reduced. Accordingly, benefits for those who do not take the personal accounts under Model 1 are shown on the accompanying chart 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.

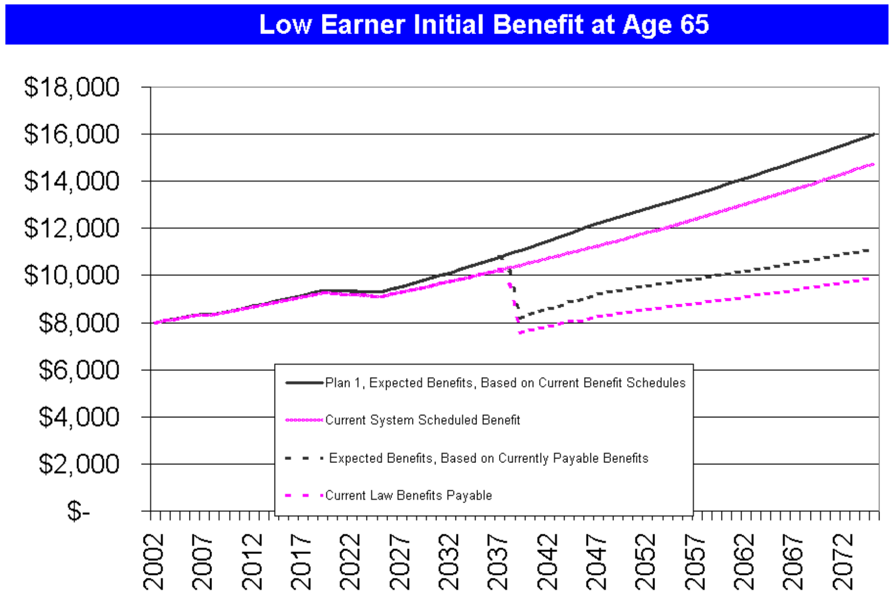
Model 1 is a flexible framework in which the accounts could be financed in a manner that either shortens or extends the period of systemic solvency. Accordingly, benefit levels for those who take the accounts are shown with the same uncertainty as shown for the current system.

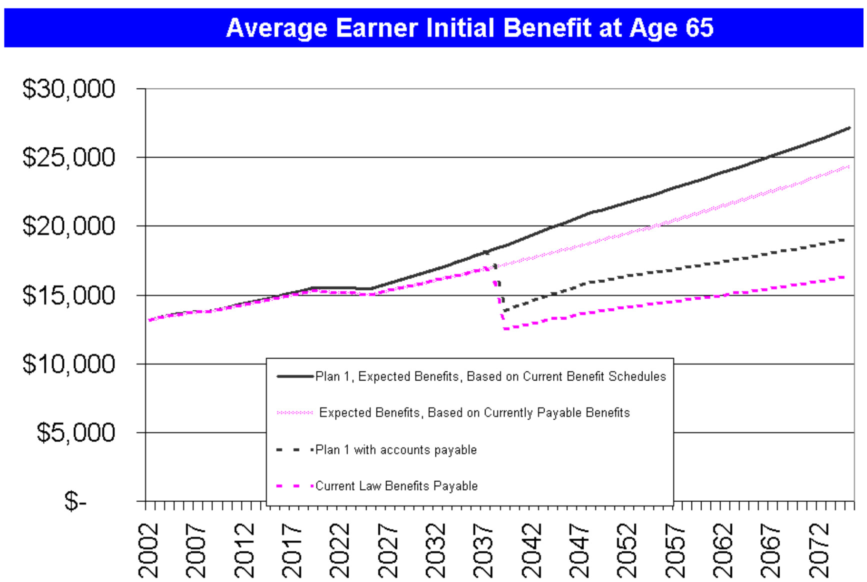
Plan 1: Two percent personal account, no changes to underlying system

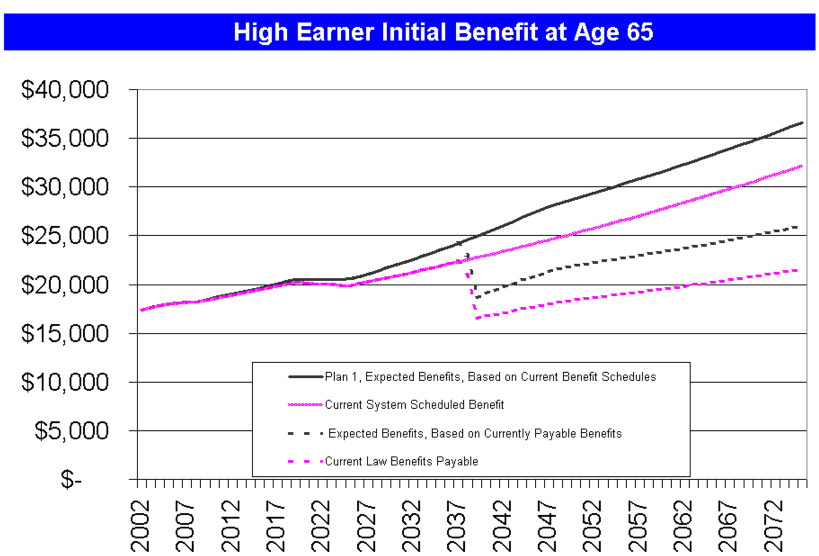
Year	Relative Earnings	Today's benefit levels	Current Law benefit	Expected benefit with account	Increase relative to today's benefit	Additional increase due to account
2032	Low	$7,644	$9,756	$10,140	$2,496	$384
	Medium	$12,624	$16,116	$16,944	$4,320	$828
	High	$16,392	$21,288	$22,620	$6,228	$1,332
2052	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 monthly 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.

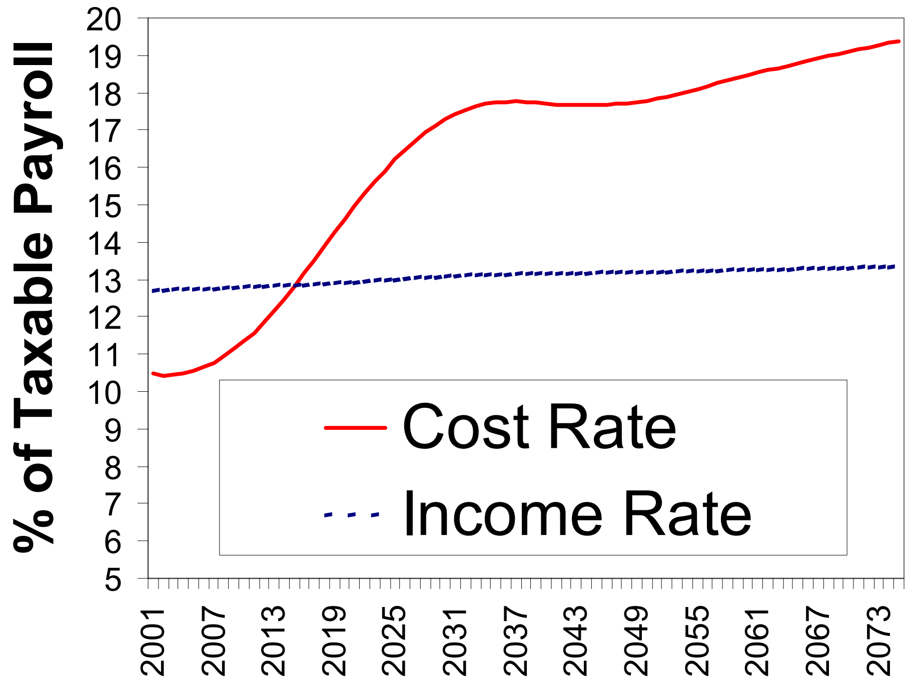
** Expected benefits with accounts assume individual invests in a 50/50 stock/bond portfolio earning an annual real rate of return, net of administrative expenses, of 4.6%. Upon retirement, the individual is assumed to have converted to a variable annuity invested in the same portfolio. Actual benefits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


Low Earner Initial Benefit at Age 65
$18,000
$16,000
$14,000
$12,000
$10,000
$8,000
$6,000
$4,000
$2,000
$-
Plan 1, Expected Benefits, Based on Current Benefit Schedules
Current System Scheduled Benefit
Expected Benefits, Based on Currently Payable Benefits
Current Law Benefits Payable
2002
2007
2012
2017
2022
2027
2032
2037
2042
2047
2052
2057
2062
2067
2072


Average Earner Initial Benefit at Age 65
$30,000
$25,000
$20,000
$15,000
$10,000
$5,000
$-
Plan 1, Expected Benefits, Based on Current Benefit Schedules
Expected Benefits, Based on Currently Payable Benefits
Plan 1 with accounts payable
Current Law Benefits Payable
2002
2007
2012
2017
2022
2027
2032
2037
2042
2047
2052
2057
2062
2067
2072


High Earner Initial Benefit at Age 65
$40,000
$35,000
$30,000
$25,000
$20,000
$15,000
$10,000
$5,000
$-
Plan 1, Expected Benefits, Based on Current Benefit Schedules
Current System Scheduled Benefit
Expected Benefits, Based on Currently Payable Benefits
Current Law Benefits Payable
2002
2007
2012
2017
2022
2027
2032
2037
2042
2047
2052
2057
2062
2067
2072

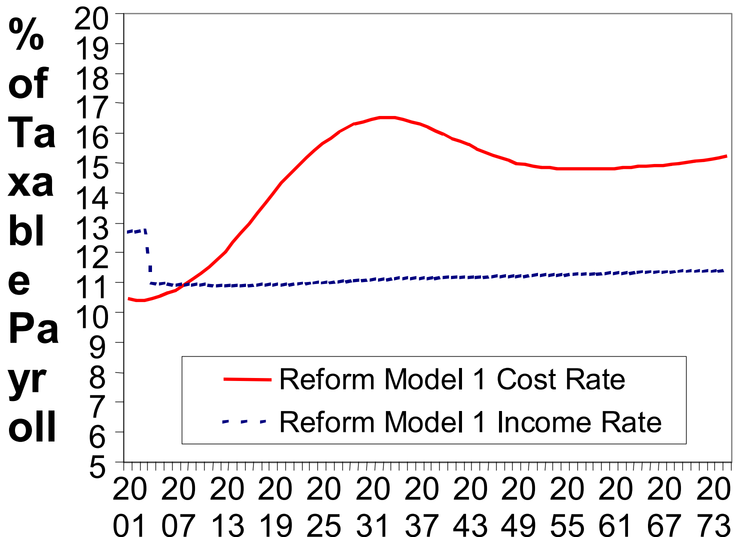
Under current law, Social Security's annual costs will exceed its income in 2016, with perpetually increasing deficits thereafter.



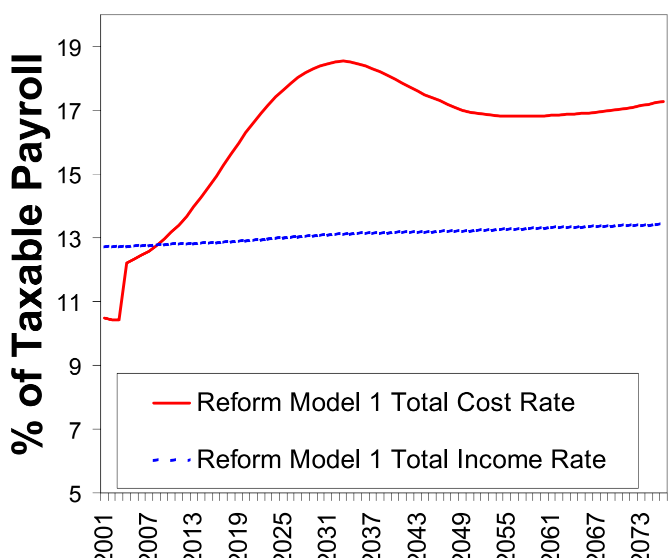
(COMMISSION DECISION: SHOW 100% or 2/3 PARTICIPATION RATE?)

Under Reform Model 1, Long-Term Cash Deficits Would Be Reduced By Approximately 36 Percent, if All Individuals Participate in Accounts.

Cost and Income Rates for the Defined Benefit portion of
Social Security Reform Model 1 Assuming 100% participation in accounts.*



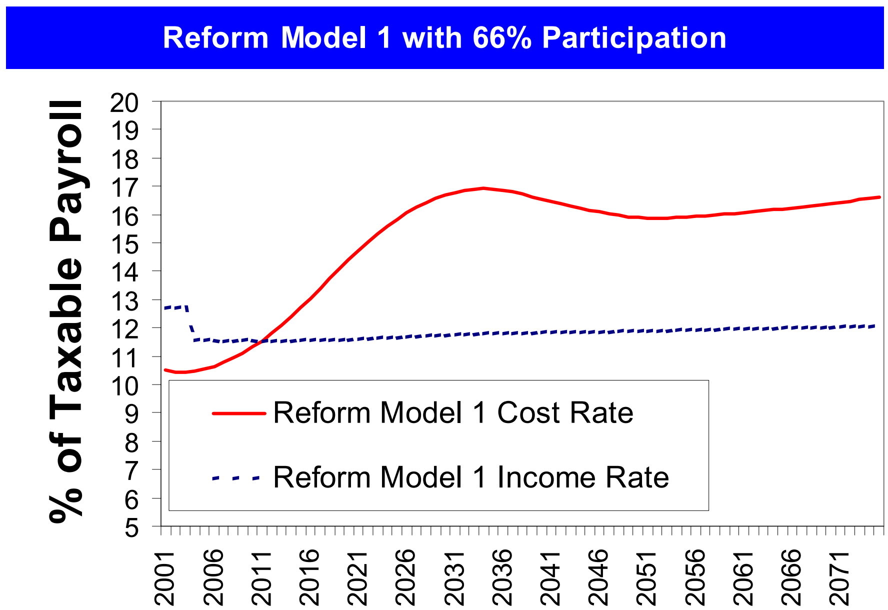
*Investments in accounts counted as revenue lost to the federal government.



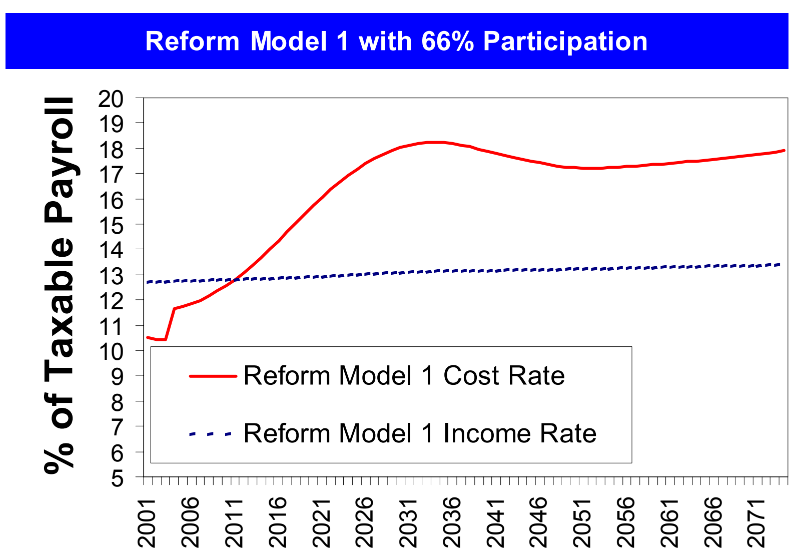
*Total Social Security system, including investments in and outlays from accounts.

Under Model 1, Long-Term Cash Deficits Would Be Reduced By Approximately 24 Percent, if Two-Thirds of Individuals Participate in Accounts.

Cost and Income Rates for DB part of Social Security Reform Model 1

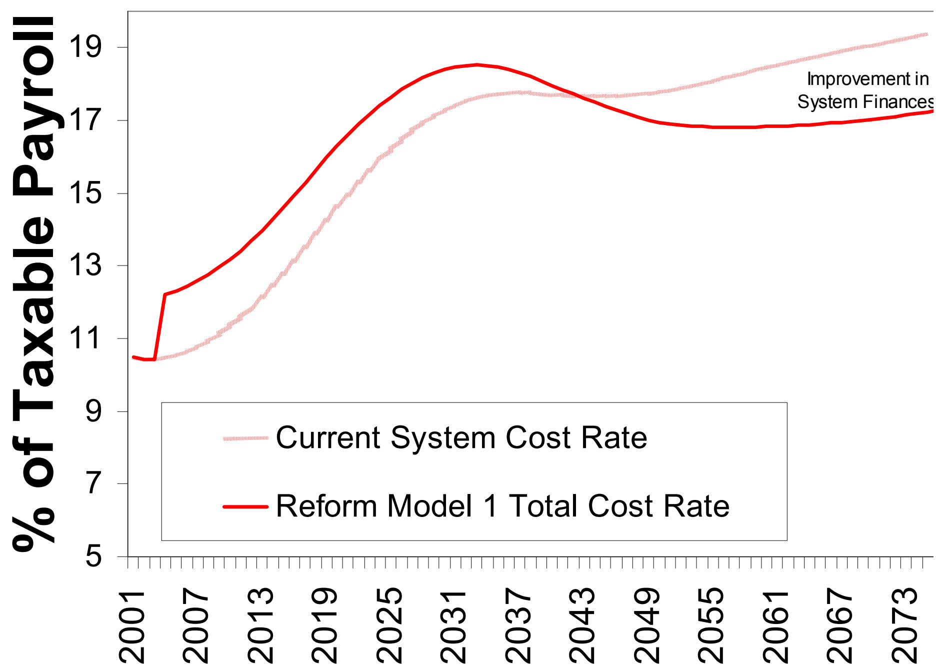


Assuming 100% participation in accounts.*
(Need footnote here)



*Total social security system, including investments in and outlays from accounts.

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



Solving the Fiscal Problem: Reducing Future Cash Deficits

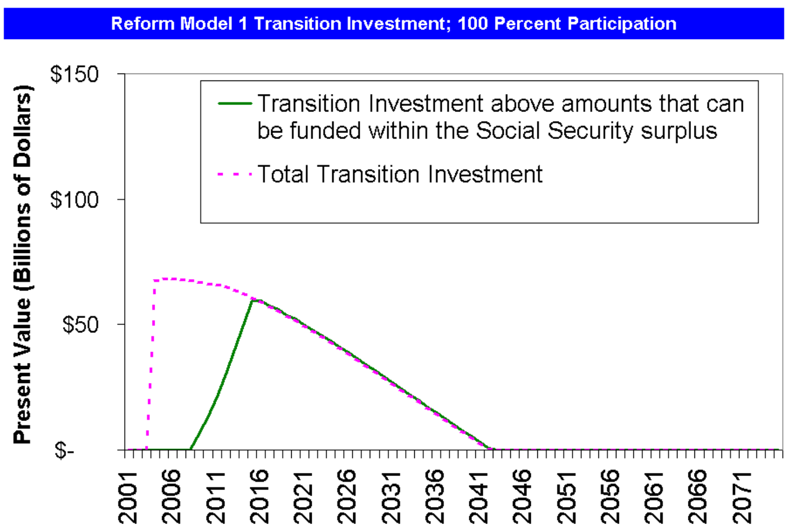
Under Reform Model 1, the present value of the program's cash deficits over the next 75 years would remain qualitatively the same as under current law -- $5.4 trillion, assuming 100 percent participation in the accounts. For 67 percent participation, the figure would be $5.3 trillon. Outside the valuation window, the picture would improve substantially relative to current law. Reform Model 1 would increase expected benefits for participants but without significantly altering 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.

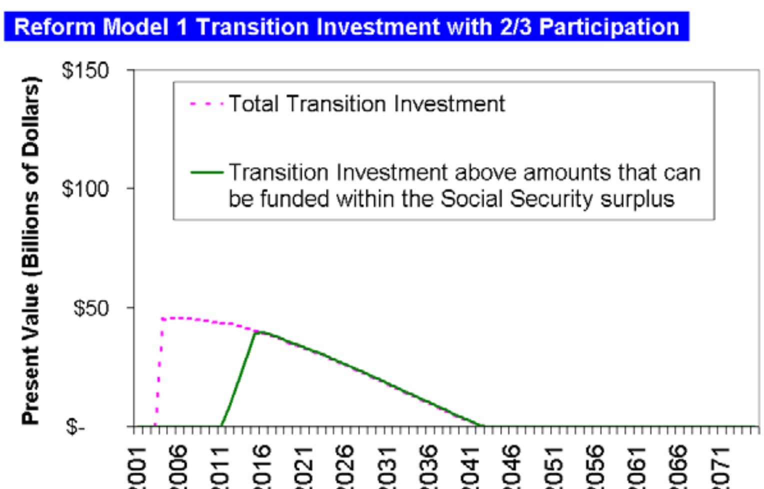
Earlier, it was noted that the long-term picture would be improved from 2043 onward under Reform Model 1. At the same time, however, the short-term financing challenge would be greater than under current law. The figures above demonstrate that through 2075, these effects have roughly canceled each other out.

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 $4.0 trillion for 100% participation, and $4.3 trillion for 67 percent participation. 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.

Transition Investment under Reform Model 1

For Reform Model 1, even under 100 percent participation, no new “transition” cash would be needed before 2009, when the investment in personal accounts for the first time exceeds current-law surpluses. The “transition” financing requirements begin comparatively small – $6 billion in present-value terms in 2009 – and would grow to a maximum of $59 billion (present-value) terms in each of 2015 and 2016.. 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. For 67 percent participation, the first new transition money would be needed in 2012, would grow to a maximum of $40 billion in 2016, and would be permanently less expensive than the old system in 2043.





The accompanying charts also show the total amount of new transition financing, including that which can be financed from existing Social Security surpluses. For Reform Model 1, however, current Social Security surpluses would be sufficient to finance all transition costs at least through 2009.

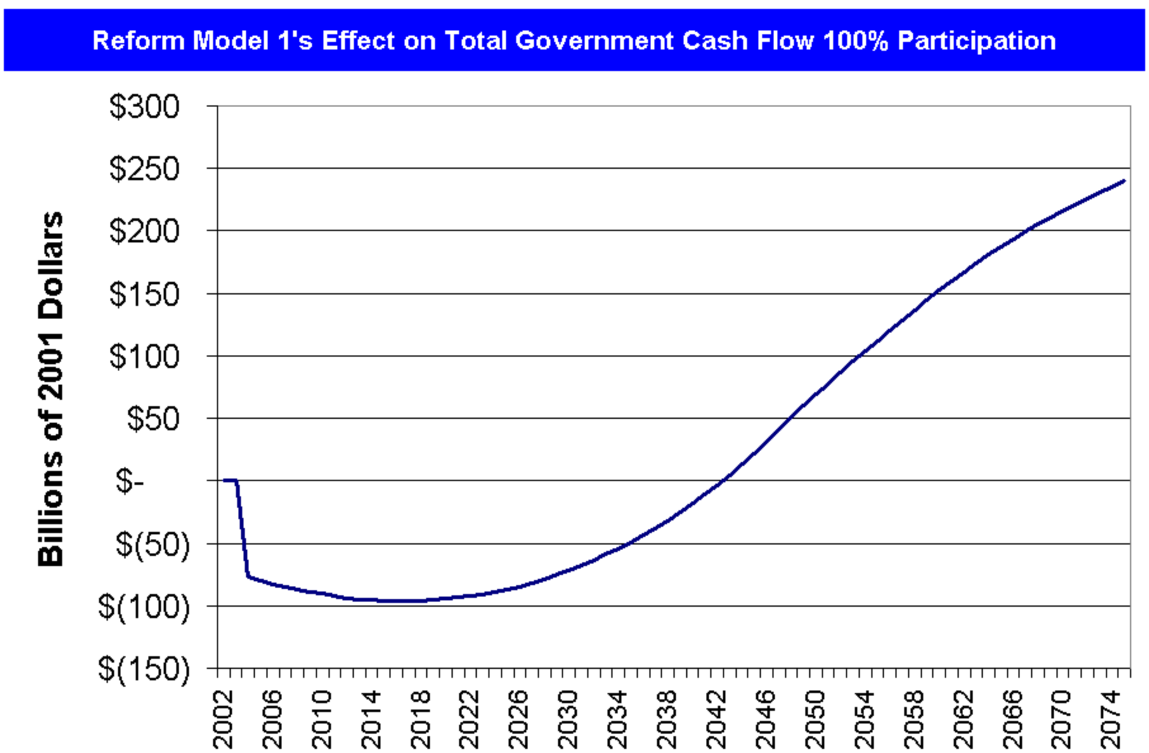
All of the figures above presume that only Social Security cash surpluses are available to provide transition financing. Were Congress to “lockbox” both cash and interest surpluses as previously intended, transition financing needs would be postponed by additional years.

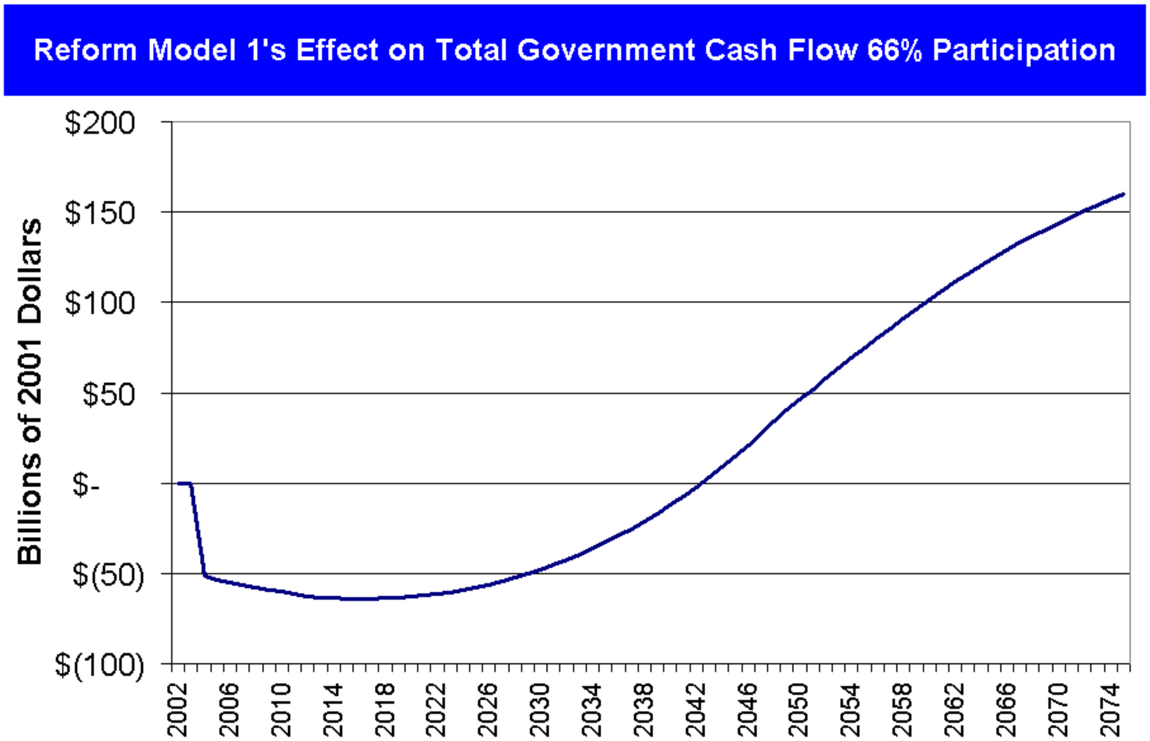
(COMMISSION DECISION: SHOW 100% or 2/3 PARTICIPATION RATE?)

Impact of Reform Model 1 on the 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 2042, assuming 100 participation. By 2075, the net positive effect would be $240 billion annually in 2001 dollars. The largest annual negative effect that this Reform Model would have on federal cash operations would be approximately $96 billion in 2001 dollars, annually, from 2014-2018. This is considerably less than the current Social Security surplus, if interest is included.

Assuming 100% Participation in Accounts, Reform Model 1 Would Have a Positive Impact on the Federal Cash Budget from 2043 Onwards
(COMMISSION DECISION: SHOW 100% or 2/3 PARTICIPATION RATE?)




Reform Model 1's Effect on Total Government Cash Flow 66% Participation
Billions of 2001 Dollars
$200
$150
$100
$50
$-
$(50)
$(100)
2002
2006
2010
2014
2018
2022
2026
2030
2034
2038
2042
2046
2050
2054
2058
2062
2066
2070
2074

Reform Model 2: Voluntary Progressive Investment of Payroll Taxes in Accounts Combined with an Inflation-Indexed Traditional System

Individuals would be given the opportunity to invest 4 percent of their taxable wages in a personal account, up to an annual maximum of $1,000. The amount of the maximum annual contribution would be indexed annually to 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. So long as personal account returns averaged more than 2 percent, a worker would receive higher total retirement benefits. Even the most conservative portfolio available, consisting only of government bonds returning 3 percent annually, would exceed the offset rate and result in higher total benefits.

Benefit growth for lower-wage workers would be accelerated and increased relative to current law. 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 in the traditional Social Security system would be indexed to price inflation rather than national wage growth beginning in 2009. In practice, this would be accomplished 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.

Benefits for widows would be increased to 75 percent of the combined benefits that would be received by the couple if both were still alive, versus 50-66 percent under current law. To target this benefit increase to widows most in need, benefits cannot be increased under this provision to a level higher than the benefit received by a survivor of an average-wage earner.

Pressures on general revenues would be reduced during the valuation period relative to current law. Regardless of participation rates for the accounts, the Trust Fund would never become insolvent. For the traditional system, exact actuarial balance would be attained without any additional general revenues. That is, no additional revenues would be required assuming 0 percent participation in accounts. For 100 and 67 percent participation, transition investment in the accounts would be followed by improvement in long-term sustainability. To ensure that the use of general revenues for transition financing does not undermine the program's self-financing ethic, funds would be transferred to the Trust Fund on a temporary basis to ensure liquidity. Subsequent permanent cash surpluses within Social Security would permit these transfers to be repaid to non-Social Security budget accounts. Although policy makers can think of this money as a "transition loan" to Social Security, the Office of the Social Security Actuary draws a technical distinction between transfers and loans in its determinations of solvency, and the Commission has thus structured the temporary transfers to meet OACT's standard of solvency.

Advantages of Reform Model 2:

- All workers would expect to benefit from personal accounts (due to the low 2% 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.

- Cash deficits under this model are manageable in size. Even in the peak years of cash deficits, they never rise to more than 1.4 percent of GDP. Under current law scheduled benefits, Social Security deficits would reach 2.5 percent of GDP.

Scorecard for Reform Model 2

New Saving and Benefits due to Personal Accounts: When fully phased in, expected benefits for a medium earner would be approximately 52 percent higher for individuals opting for relative to benefits payable from the current system. By 2015, more than $1 trillion (present value) are projected to have been accumulated in the personal accounts. This figure would surpass $2 trillion in 2028.

Additional Protections against Poverty: Under Reform Model 2, low-income earners, widows, and women and minorities generally would receive substantially higher benefits than are payable from the current Social Security system. The new minimum benefit provision would increase benefits for a 30-year minimum wage earner by approximately 40 percent by 2018 relative to today, even without the additional gains from the personal account. Benefits for widows in low-income households would be increased by as much as 50 percent through a change in the widows' benefit formula.

Positive Annual System Cash Flow Within Valuation Period: Under all participation rates for personal accounts, Social Security would be restored to permanent annual cash flow surpluses within the 75-year valuation period. Cash surpluses would resume in 2058 assuming 100 percent participation in the accounts and in 2062 assuming 0 percent participation. Assuming 67 percent participation, they would resume in 2059. As personal accounts would be highly attractive under this framework, providing significantly higher benefits without additional taxes, participation rates are expected to be high, thus accelerating the return to permanent cash surpluses.

Improvement in System Solvency: Social Security would be made permanently solvent under all participation rates for personal accounts. Assuming 0 percent participation, no additional revenues would be required. Assuming 100 percent participation in the accounts, temporary transfers would be required from the years 2025 through 2054. The total present value of these temporary transfers would be approximately 41 percent less than the additional revenue required under current law. Social Security's annual cash surpluses would permit repayment of this money beginning in 2057. (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" referred to in the Methodology section, which simply measures the period of time that the new system is more expensiev than the old.)

Reductions in the Rate of Growth in Long-Term System Costs as a Percent of GDP:
Under all participation rates, total system costs would grow no faster than the economy as a whole through the end of the valuation period, rendering the system wholly sustainable by this measure.

Improvements in 75-Year Actuarial Balance: The system would be made permanently solvent under all participation rates for personal accounts, with financing requirements as indicated above. It should be noted that the general revenue transfers required under higher account participation rates would be temporary and are outweighed (in present value terms) by savings created over the longer-term by this model.

Actuarial Balance Stable or Improving at the End of Valuation Period: Under all participation rates, actuarial balance would be increasing at the end of the valuation period, indicating permanent sustainability.

Reduction in Unfunded Benefit Obligations: Total unfunded obligations would have been reduced by $1.1 trillion (in present value) due to the personal accounts, in addition to the savings resulting from balancing the traditional system. For 67 percent participation, the progress due to the personal accounts alone would be approximately $750 billion, in present value terms.

Benefit Projections for Reform Model 2

Reform Model 2 illustrates how it is possible to significantly increase total benefits relative to the current system.

Under Reform Model 2, benefits for those who do not opt for personal accounts would grow at exactly the rate that is affordable under the current system without tax increases. Accordingly, the accompanying charts provide a direct comparison between the benefits payable through a personal account system vs. the current system.

Under the current system, a rate of initial benefit growth slightly higher than inflation is affordable within current tax rates. Reform Model 2 would target this growth above inflation on low-income workers and widows, for those who stay wholly in the traditional system.

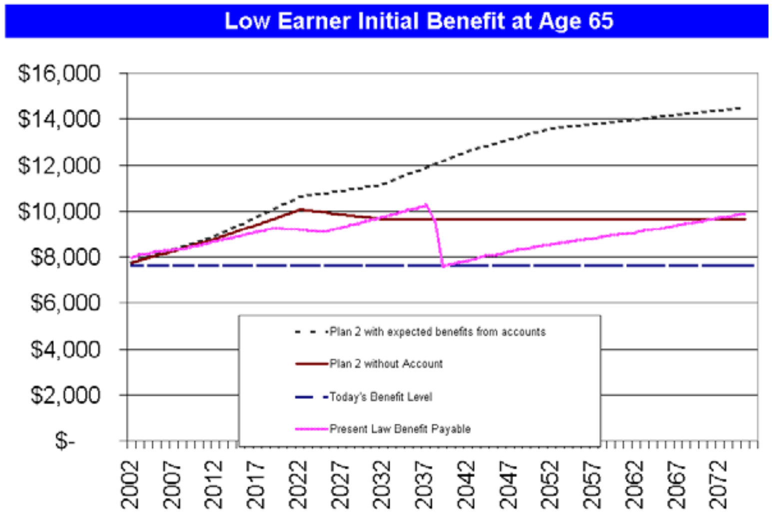
For those who opt for personal accounts, considerably higher benefits would be obtainable. All workers would expect significantly higher benefits, either than are paid today, or that the existing system can afford in the future.

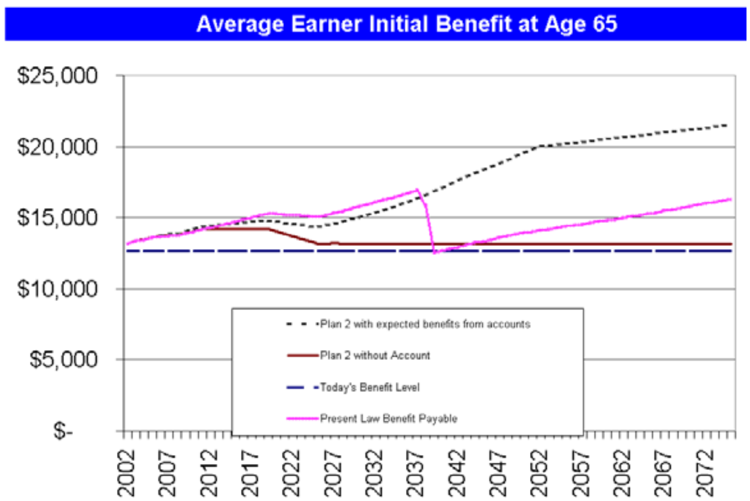
Plan 2: Price indexed system

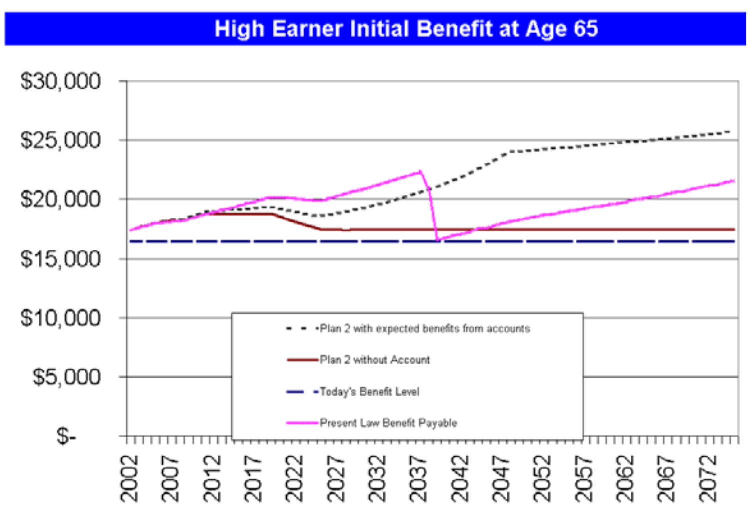
Year	**Relative Earnings**	**Today's benefit levels**	**Current Law benefit**	**Expected benefit with account**	**Increase relative to today's benefit**	**Additional increase due to account**
2032	Low	$7,644	$9,756	$11,160	$3,516	$1,488
	Medium	$12,624	$16,116	$15,444	$2,820	$2,256
	High	$16,392	$21,288	$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 monthly for low, medium, and high earners respectively but the system is projected to be 27.6% underfunded in 2052.

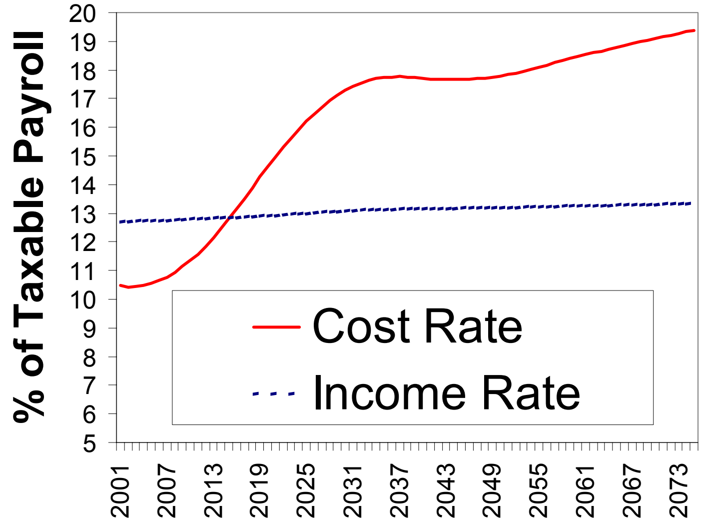
** Expected benefits with accounts assume individual invests in a 50/50 stock/bond portfolio earning an annual real rate of return, net of administrative expenses, of 4.6%. Upon retirement, the individual is assumed to have converted to a variable annuity invested in the same portfolio. Actual benefits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


Low Earner Initial Benefit at Age 65
$16,000
$14,000
$12,000
$10,000
$8,000
$6,000
$4,000
$2,000
$-
2002
2007
2012
2017
2022
2027
2032
2037
2042
2047
2052
2057
2062
2067
2072
Plan 2 with expected benefits from accounts
Plan 2 without Account
Today's Benefit Level
Present Law Benefit Payable

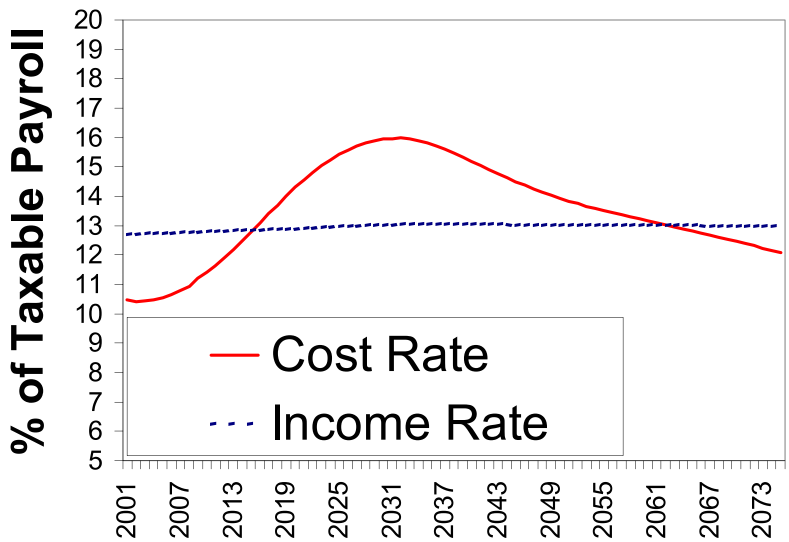

Average Earner Initial Benefit at Age 65
$25,000
$20,000
$15,000
$10,000
$5,000
$-
2002
2007
2012
2017
2022
2027
2032
2037
2042
2047
2052
2057
2062
2067
2072
Plan 2 with expected benefits from accounts
Plan 2 without Account
Today's Benefit Level
Present Law Benefit Payable


High Earner Initial Benefit at Age 65
$30,000
$25,000
$20,000
$15,000
$10,000
$5,000
$-
2002
2007
2012
2017
2022
2027
2032
2037
2042
2047
2052
2057
2062
2067
2072
Plan 2 with expected benefits from accounts
Plan 2 without Account
Today's Benefit Level
Present Law Benefit Payable

Under Current Law, Social Security's Annual Costs Will Exceed Its Income In 2016, With Perpetually Increasing Deficits Thereafter.



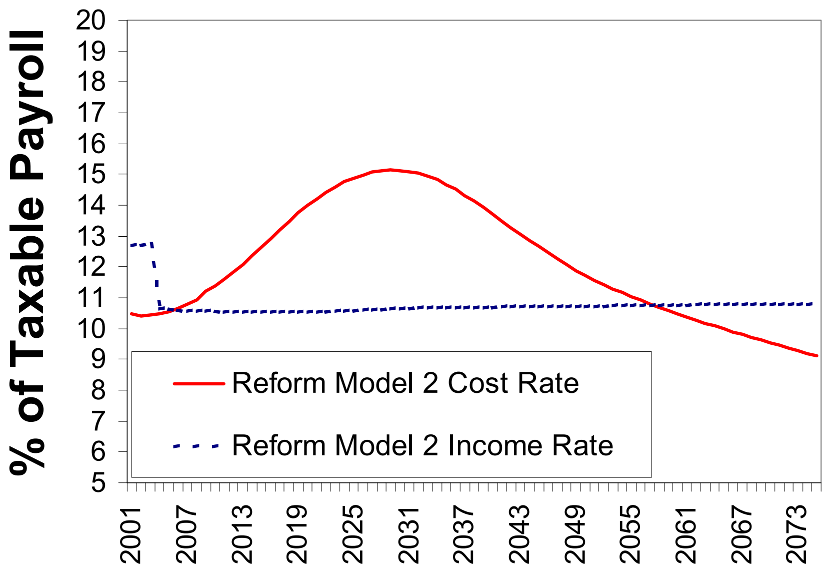
Under Reform Model 2, Social Security Would Be Actuarially Balanced Even With Zero Percent Participation In Personal Accounts.



(COMMISSION DECISION: SHOW 100% or 2/3 PARTICIPATION RATE?)

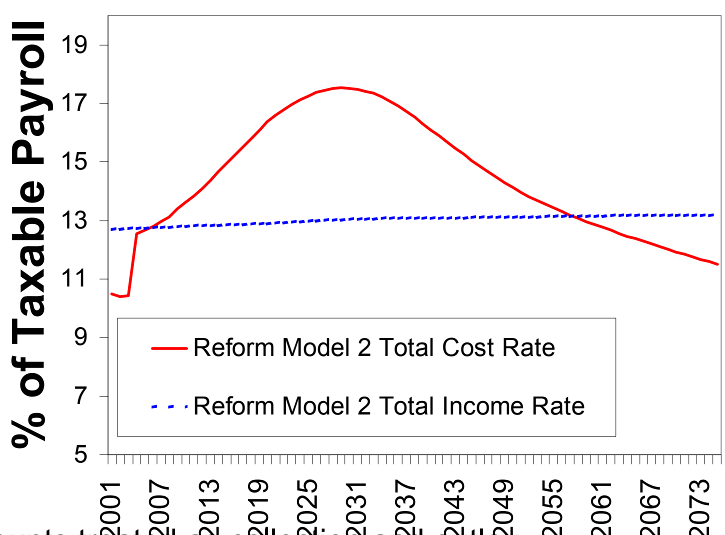
Reform Model 2 Would Restore Social Security To Permanent Surpluses Within The Valuation Period, Assuming 100 Percent Participation in Accounts.

Social Security Cost And Income Rates*



*Investments in accounts counted as revenue lost to the federal government.

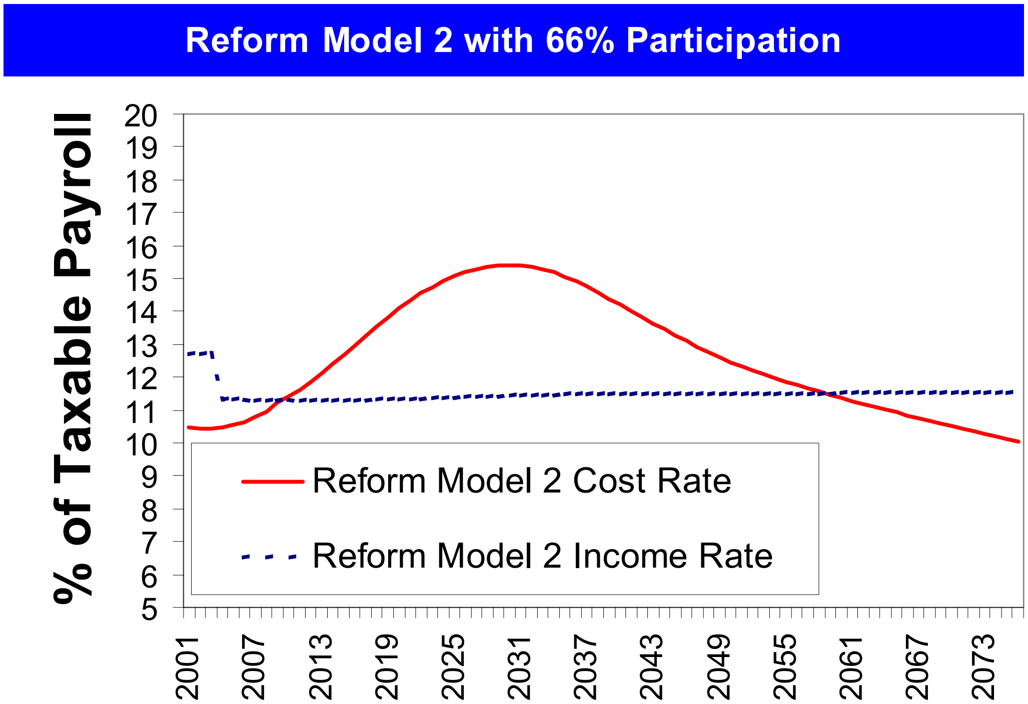
Reform Model 2 Would Restore Social Security To Permanent Surpluses Within The Valuation Period.



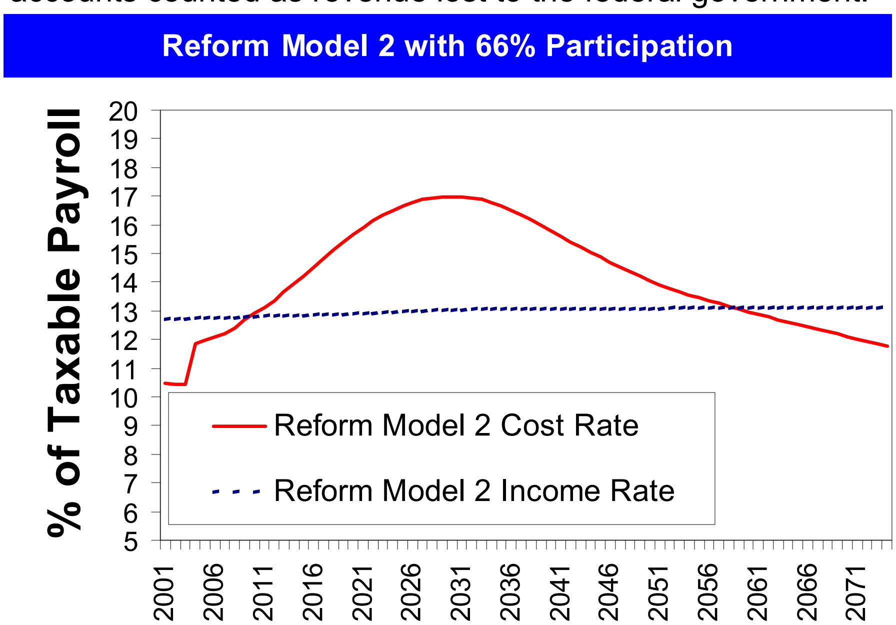
*Investments in accounts treated as collection and outlay.

Reform Model 2 Would Restore Social Security To Permanent Surpluses Within The Valuation Period, Assuming Two-Thirds Participation in Accounts.

(COMMISSION DECISION: SHOW 100% or 2/3 PARTICIPATION RATE?)

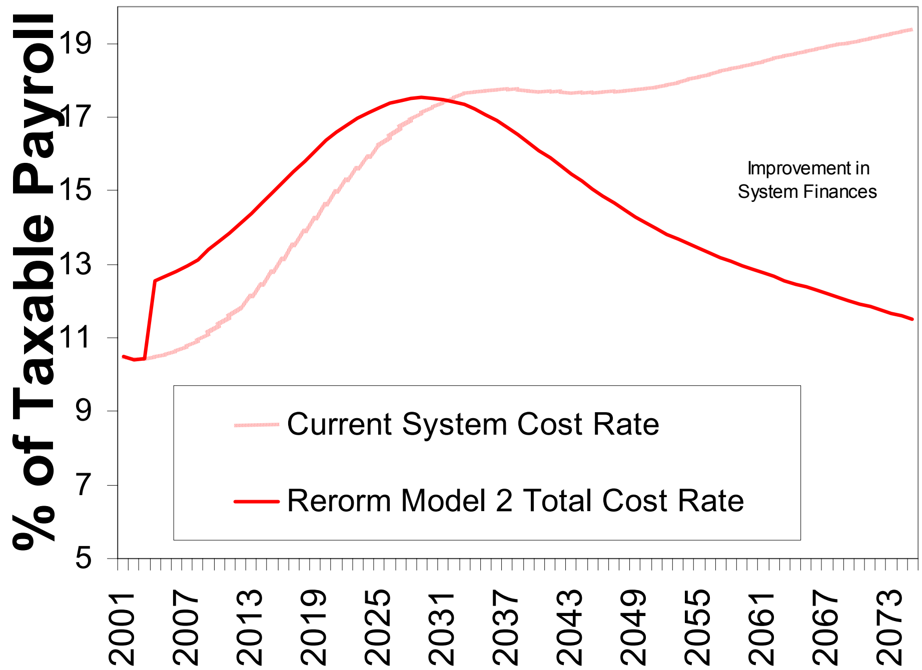


*Investments in accounts counted as revenue lost to the federal government.



*Investments in accounts treated as collection and outlay.

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



Reform Model 2: Reducing Programmatic Cash Deficits

Under Reform Model 2, Social Security's cash deficits would be reduced significantly relative to current law.

The present value of Social Security's cash deficits under current law is projected to be $5.1 trillion over the next 75 years.

Assuming 0 percent participation in personal accounts over the next 75 years under Reform Model 2, the present value of the system's cash deficits would be reduced to $1.8 trillion, an improvement of 64 percent relative to current law.

Because the personal accounts are highly attractive under Reform Model 2, it is likely that participation rates would be high. Beneficiaries would expect significantly higher benefits if they opted for personal accounts. Assuming 100 percent participation in the personal accounts, the present value of the system's cash deficits would be $3.4 trillion over the next 75 years, an improvement of 34 percent relative to current law. Assuming 67 percent participation, the figure would be $2.8 trillion, an improvement of 46 percent.

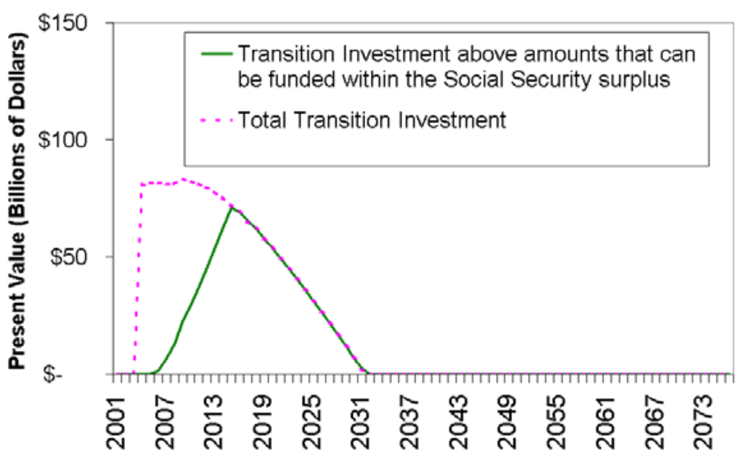
Although short-term cash deficits would be larger than if no individuals participated in accounts, higher participation rates in the personal accounts would return the system to cash surpluses more rapidly and result in larger surpluses outside the valuation window.

By any measure, Reform Model 2 would significantly reduce fiscal pressures on the rest of the federal government relative to current law. Any transition investment would be more than repaid during the long-range valuation window, reducing overall system cash gaps by anywhere from 34 percent to 64 percent.

Transition Financing Under Reform Model 2

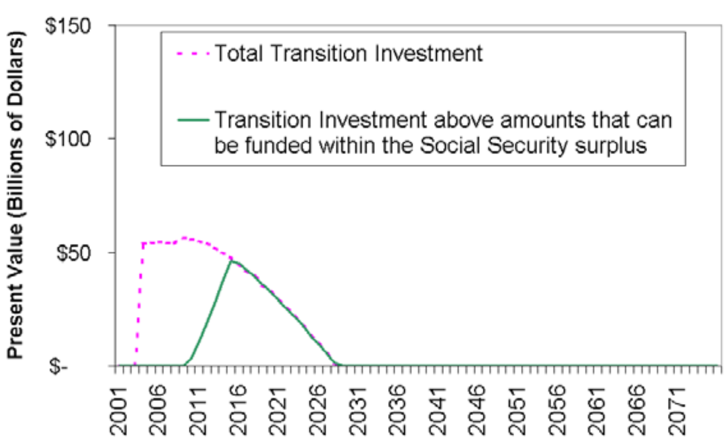
For Reform Model 2, no new "transition" cash would be needed before 2006, even with 100% participation in the accounts, when the investment in personal accounts for the first time exceeds current-law surpluses. The "transition" financing requirements begin comparatively small – $1.3 billion in present-value terms in 2006 – and would grow to a maximum of $71 billion in present-value terms in 2015. Thereafter the amount of new cash requirements for the new system would diminish, until in 2032, the new system would be permanently less expensive than the old. For 67 percent participation, the first transition cash needs would be in 2010, would grow to a maximum of $46 billion in 2015, and the new system would be less expensive than the old starting in 2029.

Reform Model 2 Transition Investment: 100 Percent Participation



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



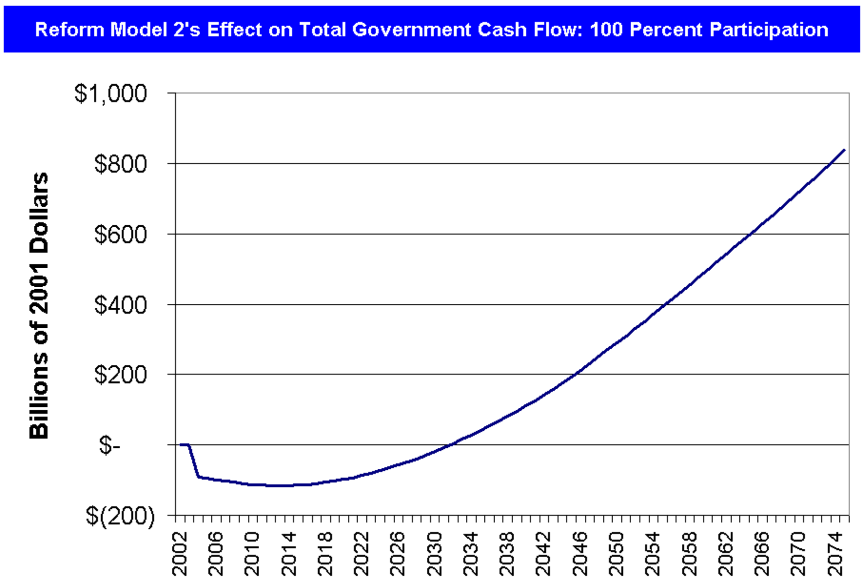
(COMMISSION DECISION: SHOW 100% or 2/3 PARTICIPATION RATE?)

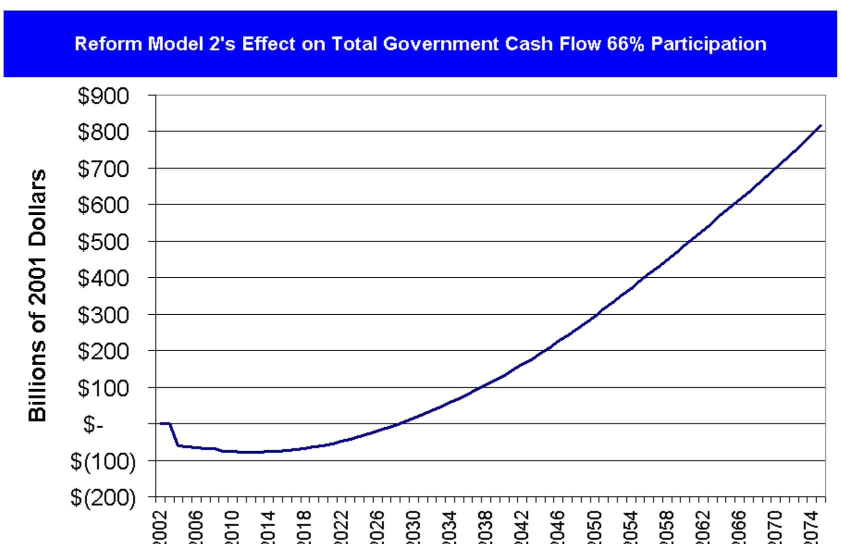
Impact of Reform Model 2 on the Unified Federal Budget

Assuming 100 percent participation in the personal accounts, Reform Model 2 would have a net positive impact on the federal cash operations by 2032, with positive gains increasing throughout the valuation period and reaching $838 Billion annually (in 2001 dollars) by 2075. The largest negative impacts on the federal budget would be $116 Billion (in 2001 dollars) in year 2013.

Assuming no participation in personal accounts, eventual improvements in the net annual cash budget would not grow quite as large ($772 billion annually in 2075) by the end of the valuation period, but net effects on total federal budget balance would be positive throughout almost the entirety of the valuation period.

(COMMISSION DECISION: SHOW 100% or 2/3 PARTICIPATION RATE?)





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

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. To reconcile these two objectives requires additional revenues.

Individuals would be given the opportunity to invest in voluntary personal accounts. 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) from their current payroll taxes. For low-income workers, the voluntary contribution would be subsidized by rebating 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 compounded at a real interest rate of 2.5 percent. Accordingly, even if individuals invested only in government bonds returning 3 percent, the most conservative portfolio available, their total retirement benefits will increase due to the accounts.

The initial formula for the traditional Social Security benefits would grow at a rate that is approximately halfway between wage indexing and price indexing. The rationale for this rate of growth is to adjust the rate of growth in benefits for future changes in life expectancy, without changing the retirement age.

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 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.

Growth in traditional Social Security benefits for lower-wage workers would be accelerated and increased relative to current law. By 2018, a worker who works for 30 years at the minimum wage would receive a benefit at least as high as the poverty level, a protection that does not exist under the current system.
Traditional Social Security benefits for widows would be increased to 75 percent of the combined benefits that would be received by the couple if both were still alive, versus 50-66 percent under current law. To target this benefit increase to widows most in need, benefits cannot be increased under this provision to a level higher than the benefit received by a survivor of an average-wage earner.

Additional revenues would be committed to the Social Security system.
As scored in the accompanying presentation, these revenues would take the form of dedicated revenue transfers, starting at 0.34 percent of national taxable payroll 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.

Maintenance of scheduled benefits and replacement rates.
These benefit and revenue changes would have the effect of maintaining or exceeding scheduled benefit levels and wage replacement rates from a combination of the traditional Social Security benefit and the personal retirement account.

Solvency would be maintained through a combination of permanent and temporary commitments of general revenues. For the traditional system, exact actuarial balance would be attained through the use of targeted general revenues as above. To ensure that the use of general revenues for transition financing does not undermine the program's self-financing ethic, funds would be transferred to the Trust Fund on a temporary basis to ensure liquidity. Subsequent permanent cash surpluses within Social Security would permit these transfers to be repaid to non-Social Security budget accounts. Although policy makers can think of this money as a "transition loan" to Social Security, the Office of the Social Security Actuary draws a technical distinction between transfers and loans in its determinations of solvency, and the Commission has thus structured the temporary transfers to meet OACT's standard of solvency.

Advantages of Model 3:

1. Workers who opt for PRAs can reasonably expect to receive total Social Security benefits (including their PRA) exceeding current law promised benefits.

2. 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.

3. The primary source of additional revenue is a voluntary 1% add-on to the new PRAs. The add-on is matched by a redirection of part of the payroll tax—2.5% up to an annual maximum of $1000--to the PRA.

4. 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.

5. Some permanent transfers of new revenues are added from dedicated sources to the pay-as-you-go Social Security system

6. Intergenerational equity is maintained by holding constant the present value of lifetime benefits from Social Security as longevity increases.

7. Work incentives are augmented by rewarding delayed retirement and by steeper actuarial penalties for early retirement.

8. The obligations of future generations to pay unfunded obligations are dramatically reduced.

9. 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% offset interest rate.

10. 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.

Scorecard for Reform Model 3

New Saving and Benefits due to Personal Accounts: When fully phased in, expected benefits for a medium earner would be approximately 56 percent higher for individuals who opt to participate in accounts relative to those payable from the current system. By 2013, more than $1 trillion (present value) are projected to have been accumulated in the personal accounts. This figure would surpass $2 trillion in 2023. The extent to which this is new saving would depend on the amount of pre-existing saving displaced for add-on contributions to the accounts.

Additional Protections against Poverty: Under Reform Model 3: low-income earners, widows, and women and minorities generally would receive substantially higher benefits than are payable from the current Social Security system. The new minimum benefit provision would increase benefits for a 30-year minimum wager earner by approximately 17% by 2018, even without the additional gains from the personal account, and this amount would grow over time faster than inflation. This minimum benefit would be even more generous for individuals with the same career earnings but more years of work. Benefits for widows in low-income households would be increased by as much as 50% through a change in the widows' benefit formula.

Positive Annual System Cash Flow Within Valuation Period: Under all participation rates, projected cash deficits would be reduced relative to current law. Under 100 percent participation, the system would return to positive cash flow by 2062, providing that additional revenue has been collected to fund this framework's general revenue transfers. For 67 percent participation this would occur in 2072. Net of the obligation to fund the transfers, the system would return to cash surpluses only outside the valuation period. Under 0 percent participation, the system would not return to positive cash flow within the valuation period.

Improvement in System Solvency: The system would be made permanently solvent under all participation rates for personal accounts. Assuming 100 percent participation in the accounts, temporary transfers would be required from the years 2028-2056 in addition to the general revenues tapped to sustain the traditional Social Security system. The total present value of these would be approximately 69 percent less than the revenue requirements under current law. Repayment of this money could commence in 2058 within the financing of this particular Reform Model. Total general revenue requirements, including permanent and temporary transfers, would be approximately 33% less than current law. (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" referred to in the Methodology section, which simply measures the period of time that the new system is more expensive than the old.)

Reduce Rate of Growth in Long-Term System Costs as a Percent of GDP:
Total system costs would grow slower than GDP through the end of the valuation period, rendering the system wholly sustainable by this measure.

Improvements in 75-Year Actuarial Balance: The system would be made permanently solvent under all participation rates for personal accounts, with financing requirements as indicated above.

Actuarial Balance not Deteriorating at the End of Valuation Period: Under all participation rates, the system would experience either increasing surpluses or decreasing annual cash deficits by the end of the valuation period. Under 0 percent participation, continuing cash deficits would mean that the actuarial balance would not yet be increasing. For 100 percent participation, actuarial balance would be improving providing that revenues have been made available to fund general revenue transfers.

Reduction in Unfunded Benefit Obligations: Total unfunded obligations would have been reduced $1 trillion (in present value) from the personal accounts, in addition to the savings resulting from balancing the traditional system. For 67 percent participation, this figure would be approximately $700 billion.

Benefit Projections for Reform Model 3

Reform Model 3 illustrates how it is possible to exceed currently scheduled benefit promises through personal accounts without recourse to the large tax increases that the current system would require.

Under Reform Model 3, benefits for those who opt for the personal accounts would be significantly higher than those who do not, even without the 1% add-on contribution, but the 1% add-on would bring total benefits to a higher level than currently scheduled promises.

These gains would still exist, although to a lesser extent, under the more conservative assumption of a fixed annuity upon retirement.

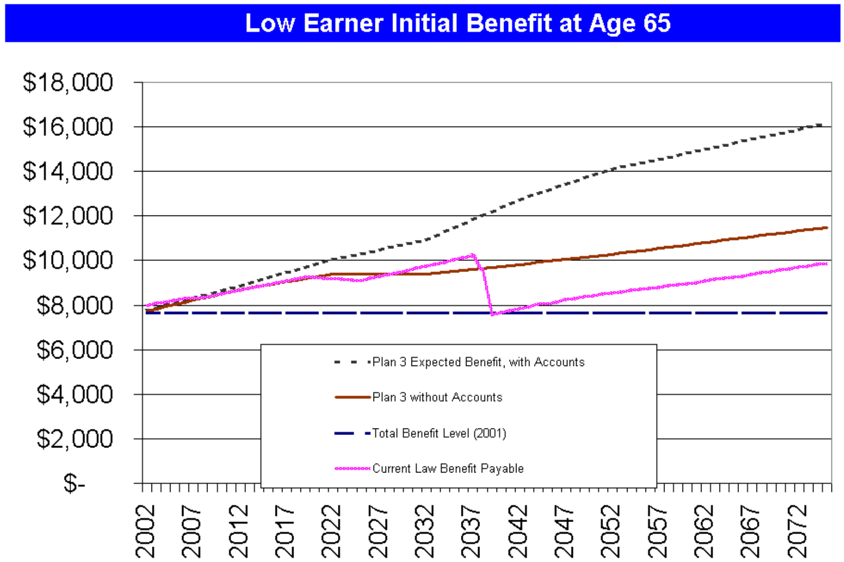
Like Reform Model 2, Reform Model 3 would provide for benefit growth, among those who do not opt for personal accounts, for low-wage workers and widows.

Plan 3: 1% "Add-on" contribution allows for benefit growth exceeding currently scheduled benefits

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

* $986, $1,628 and $2,151 are currently scheduled monthly for low, medium, and high earners respectively but the system is projected to be 27.6% underfunded in 2052.

** 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
$18,000
$16,000
$14,000
$12,000
$10,000
$8,000
$6,000
$4,000
$2,000
$-
Plan 3 Expected Benefit, with Accounts
Plan 3 without Accounts
Total Benefit Level (2001)
Current Law Benefit Payable
2002
2007
2012
2017
2022
2027
2032
2037
2042
2047
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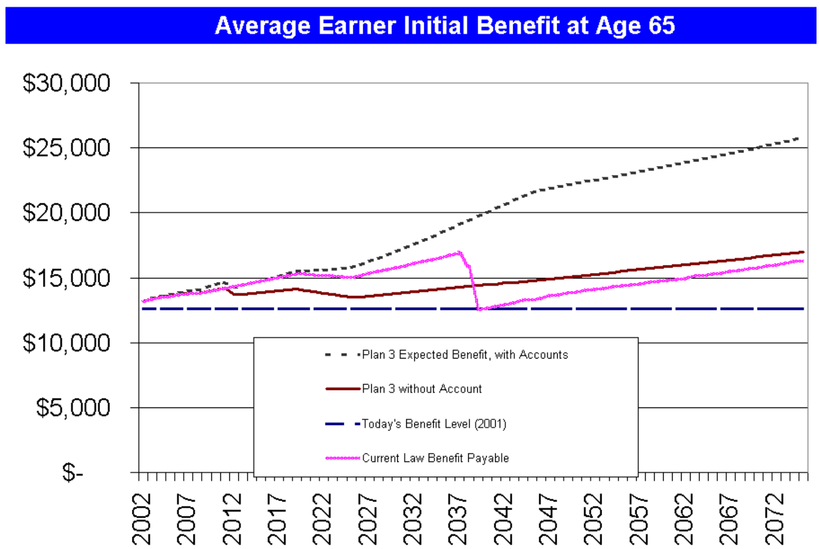
2057
2062
2067
2072


Average Earner Initial Benefit at Age 65
$30,000
$25,000
$20,000
$15,000
$10,000
$5,000
$-
Plan 3 Expected Benefit, with Accounts
Plan 3 without Account
Today's Benefit Level (2001)
Current Law Benefit Payable
2002
2007
2012
2017
2022
2027
2032
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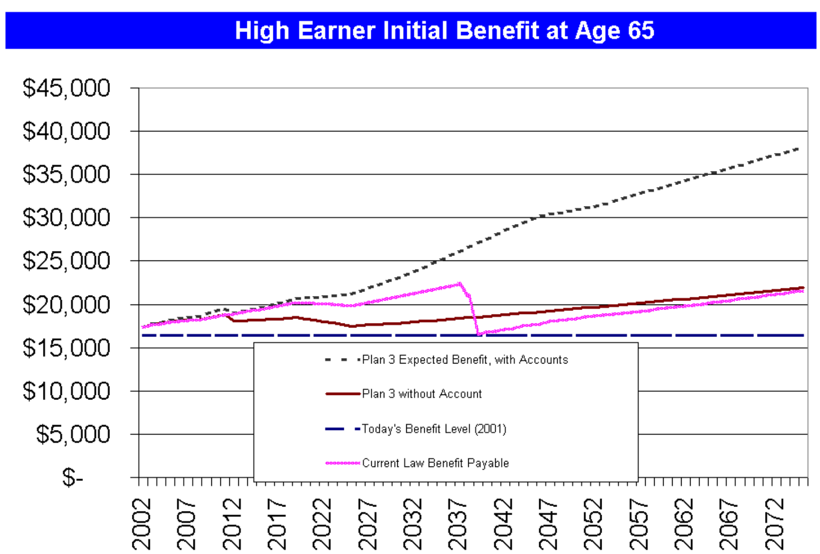
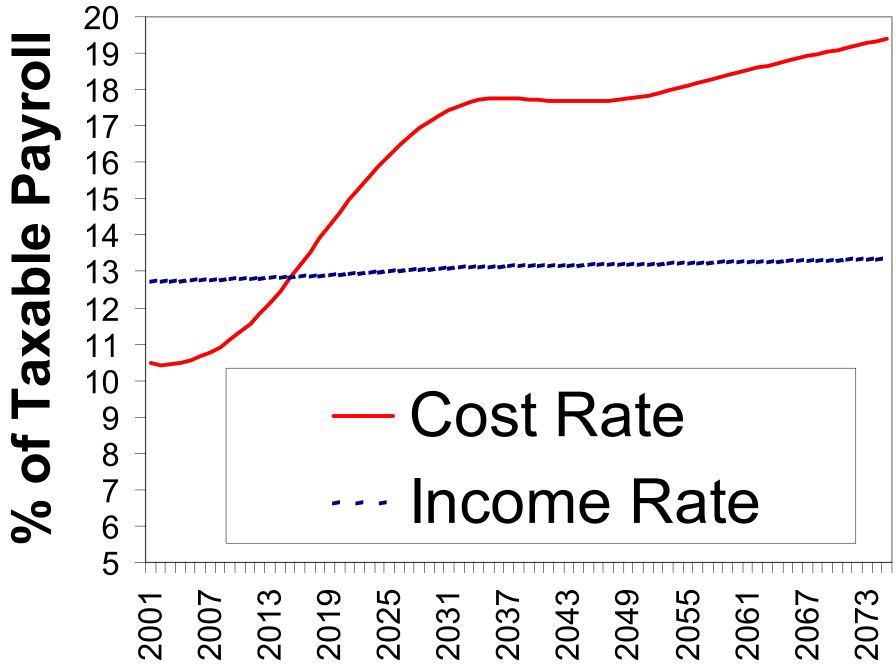
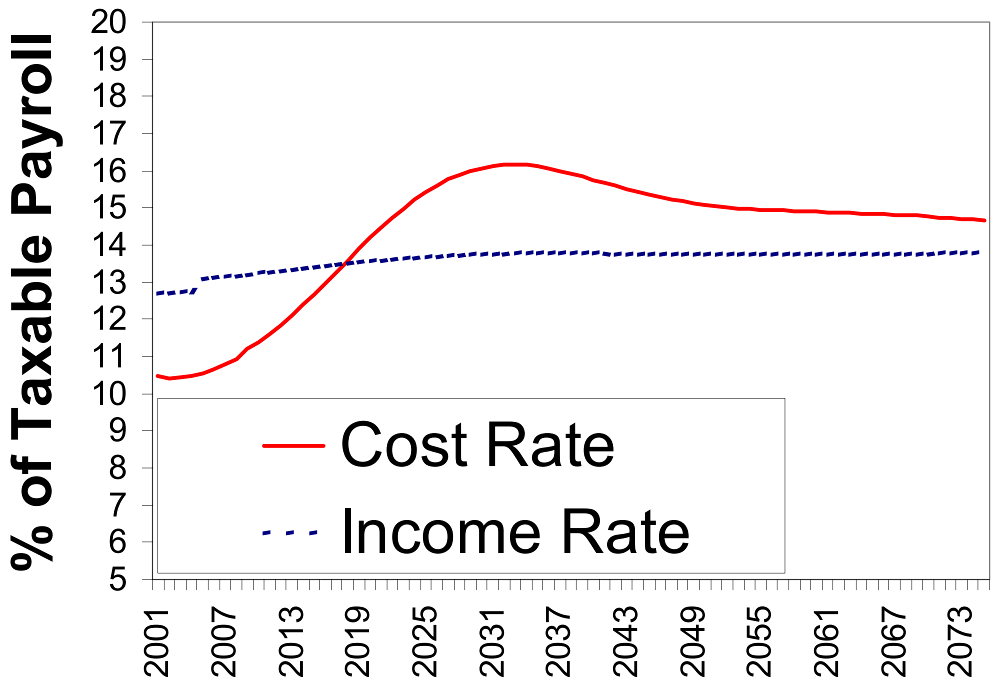

High Earner Initial Benefit at Age 65
$45,000
$40,000
$35,000
$30,000
$25,000
$20,000
$15,000
$10,000
$5,000
$-
Plan 3 Expected Benefit, with Accounts
Plan 3 without Account
Today's Benefit Level (2001)
Current Law Benefit Payable
2002
2007
2012
2017
2022
2027
2032
2037
2042
2047
2052
2057
2062
2067
2072

[1] 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 (carryover of footnote) the annual DB downward over 2020-2025. This gradual adjustment process would give people ample time to compensate by planning to work longer or save more privately.

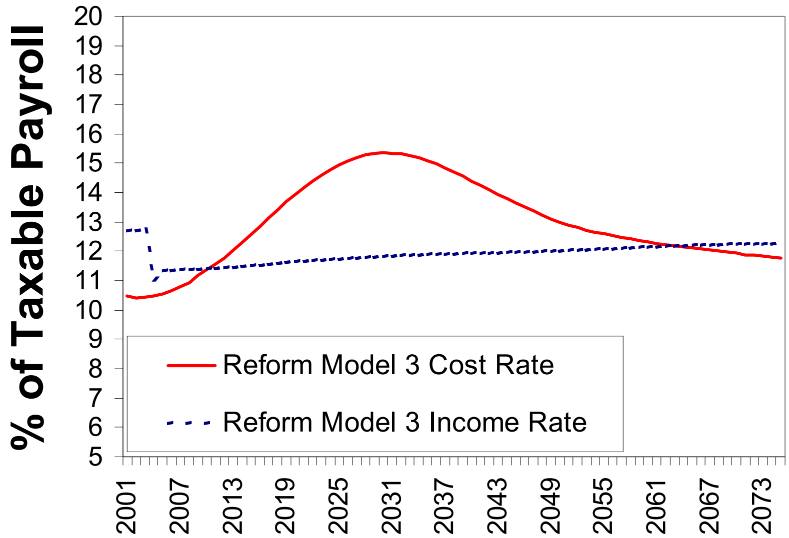
Income And Cost Rates Under Current Law



Under Reform Model 3, Social Security Would Be Actuarially Balanced Even With Zero Percent Participation In Personal Accounts.

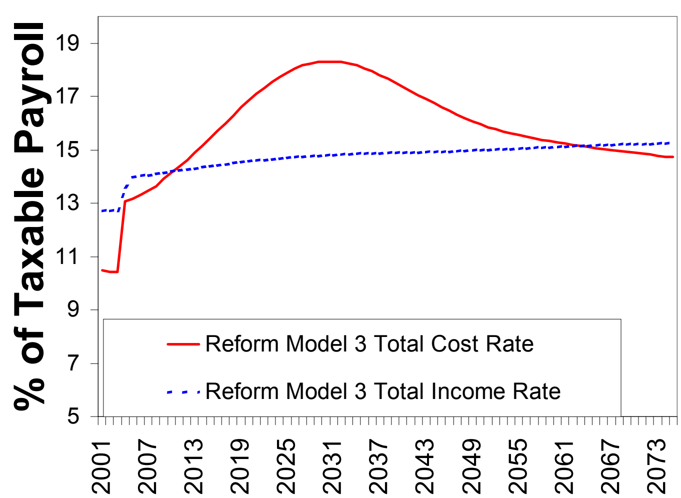


Social Security Cost and Income Rates *



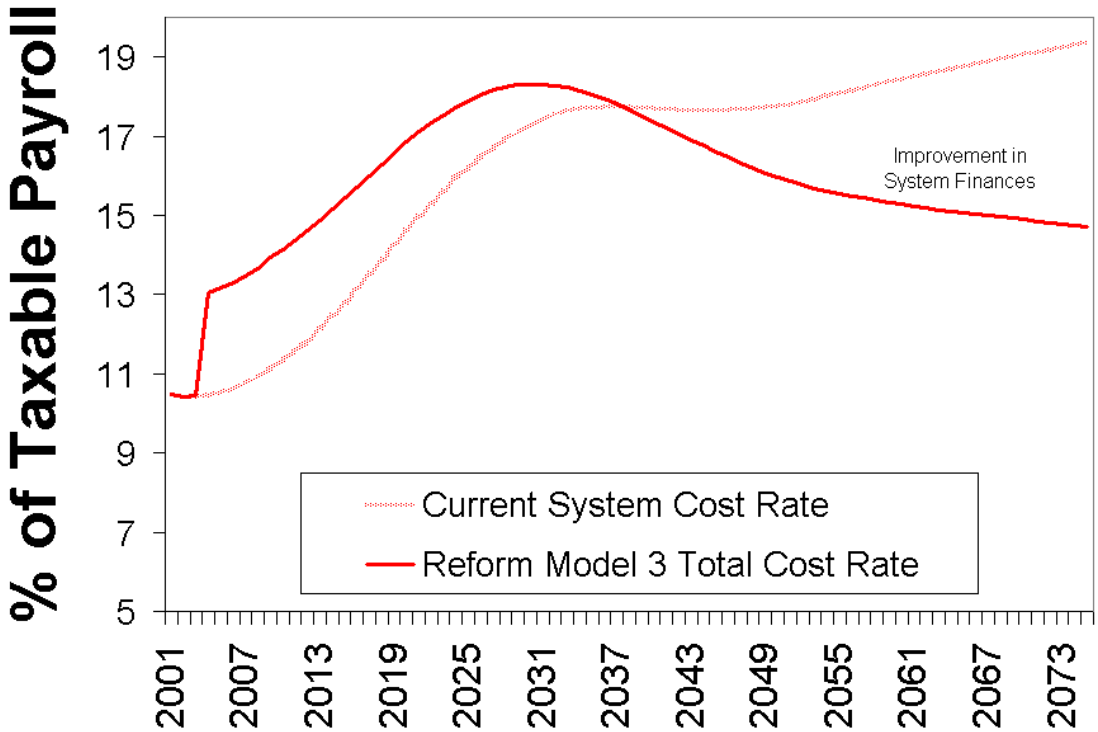
*Investments in accounts counted as revenue lost to the federal government.

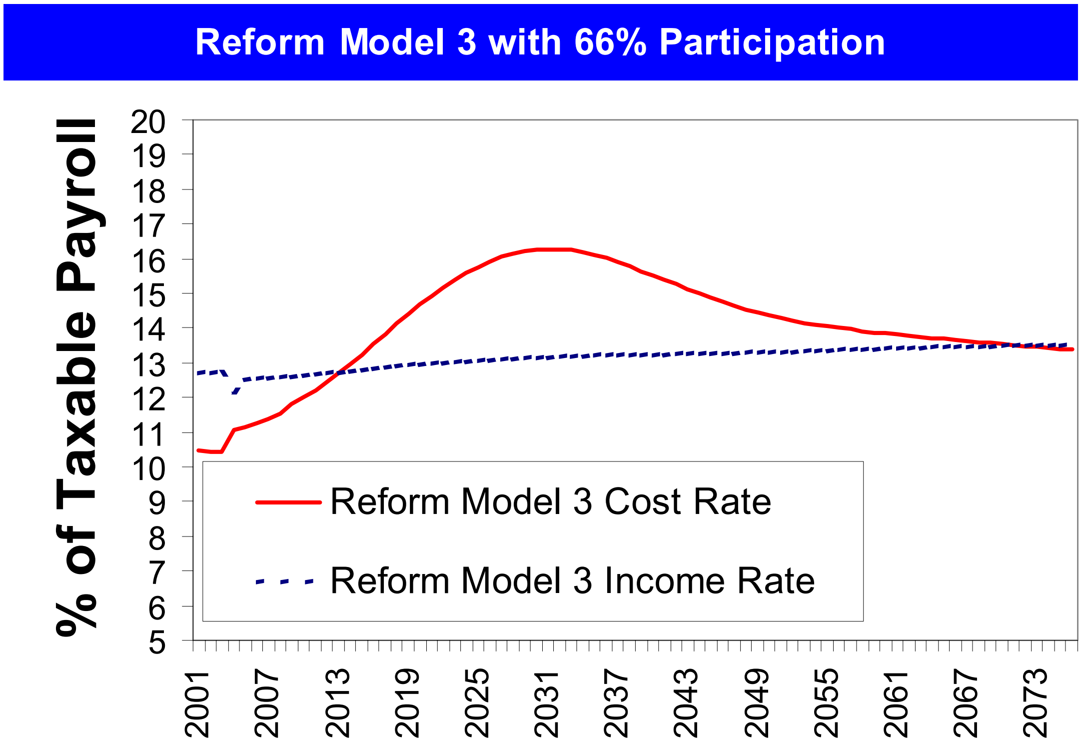
(COMMISSION DECISION: SHOW 100% or 2/3 PARTICIPATION RATE?)
Reform Model 3 Would Restore Social Security To Permanent Surpluses Within The Valuation Period, Assuming 100% Participation in Accounts.
Social Security Cost and Income Rates*



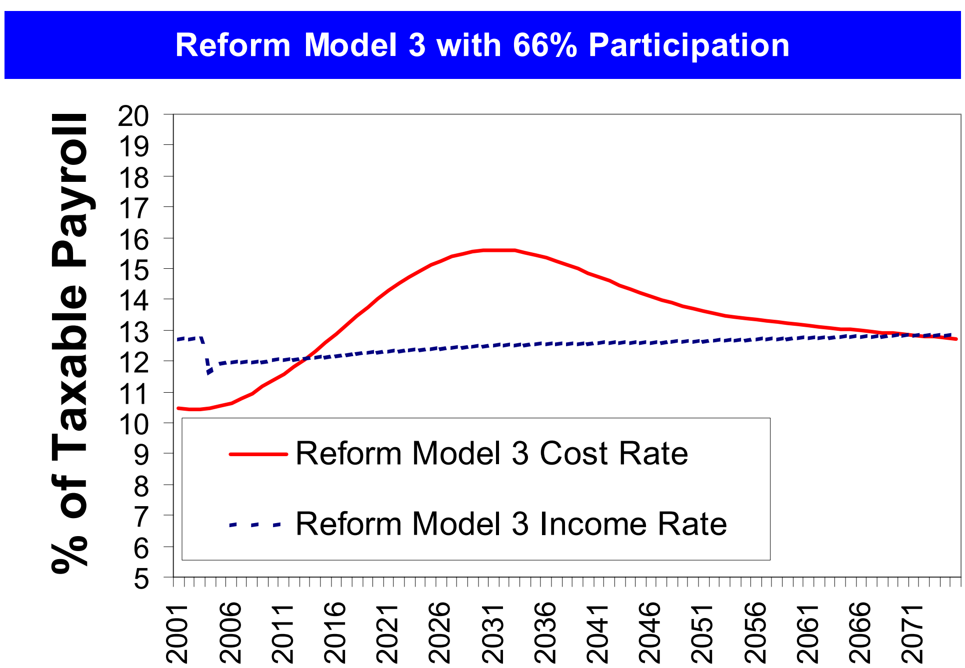
*Investments in accounts treated as collection and outlay.

Reform Model 3 Would Vastly Improve Systemic Finances Relative To Current Law





*Investments in accounts counted as revenue lost to the federal government.



*Investments in accounts treated as collection and outlay.

Reform Model 3: Reducing Programmatic Cash Deficits

Under Reform Model 3, Social Security's cash deficits would be reduced significantly relative to current law.

The present value of Social Security's cash deficits under current law projects to be $5.1 trillion over the next 75 years.

Assuming 0 percent participation in personal accounts over the next 75 years under Reform Model 3, the present value of the system's cash deficits would be reduced to $2.7 trillion, an improvement of 48 percent relative to current law.

Because the personal accounts are attractive under Reform Model 3, it is likely that participation rates would be high. Beneficiaries would expect significantly higher benefits if they opted for personal accounts. Assuming 100 percent participation in the personal accounts, the present value of the system's cash deficits would be $3.4 trillion over the next 75 years, an improvement of 32 percent relative to current law. For 67 percent participation in the accounts, the figure would be $3.1 trillion, an improvement of 38 percent.

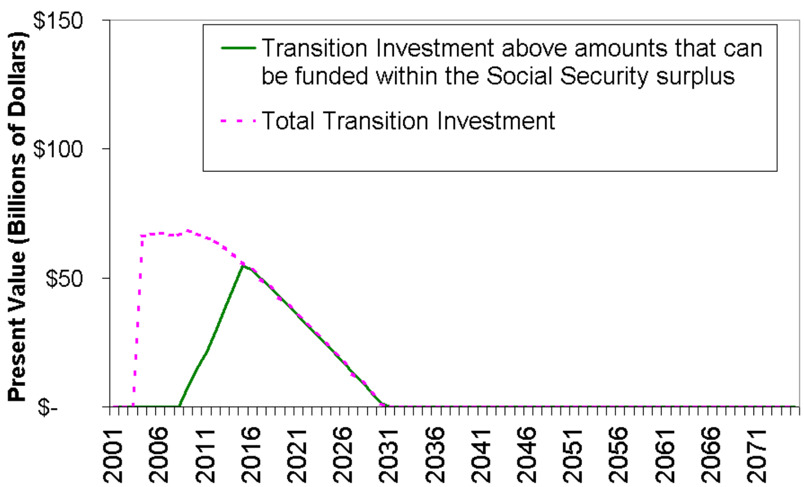
By any measure, Reform Model 3 would significantly reduce pressures on the rest of the federal government, relative to current law. Any "transition investment" would be more than repaid during the long-range valuation window, reducing overall system cash gaps by anywhere from 32 percent to 48 percent.

Relative to Reform Model 2, Reform Model 3 would make less progress in reducing cash gaps if 0 percent participation in the accounts is assumed. This reflects the fact that Reform Model 2 takes stronger measures to bring the traditional system to solvency. For 100 percent participation in the accounts, however, the two systems have roughly similar effects in reducing cash deficits. This is because Reform Model 3 has a somewhat steeper offset rate for participation in the personal accounts than does Reform Model 2.

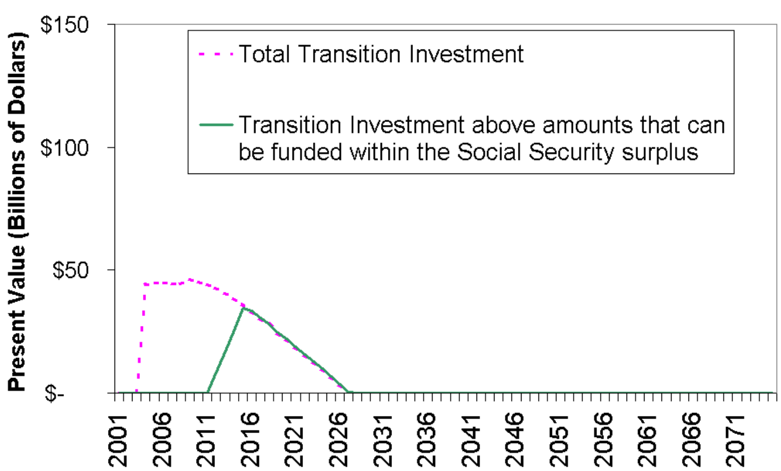
Transition Financing Under Reform Model 3

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 2009, even assuming 100 percent participation, when the investment in personal accounts for the first time exceeds current-law surpluses (must revise for new effective dates.) The “transition” financing requirements begin comparatively small – $8 billion in present-value terms in 2009 – and would grow to a maximum of $55 billion in present-value terms in 2015. Thereafter the amount of new cash requirements for the new system would diminish, until in 2031, 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 2035, as shown on the following page.

Reform Model 3 Transition Investment with 100% Participation



Reform Model 3 Transition Investment with 66% Participation

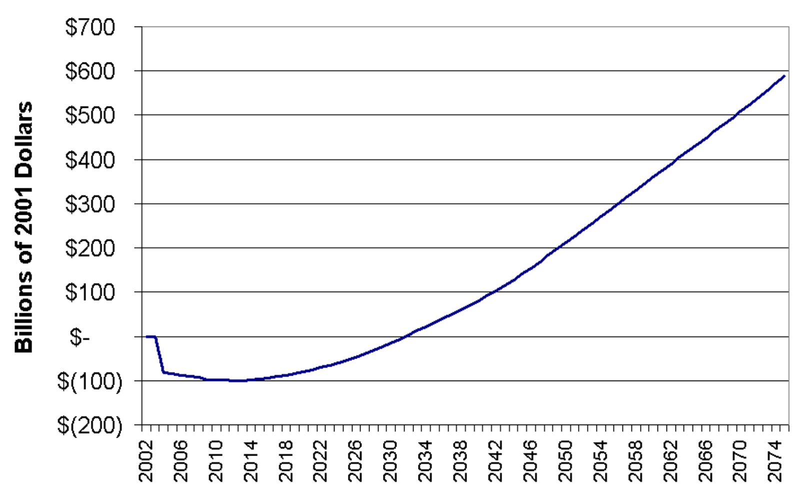


Again, all of the figures above presume that only Social Security cash surpluses are available to provide transition financing. Were Congress to “lockbox” both cash and interest surpluses as previously intended, transition financing needs would be postponed by additional years.

Impact of Reform Model 3 on the Unified Federal Budget

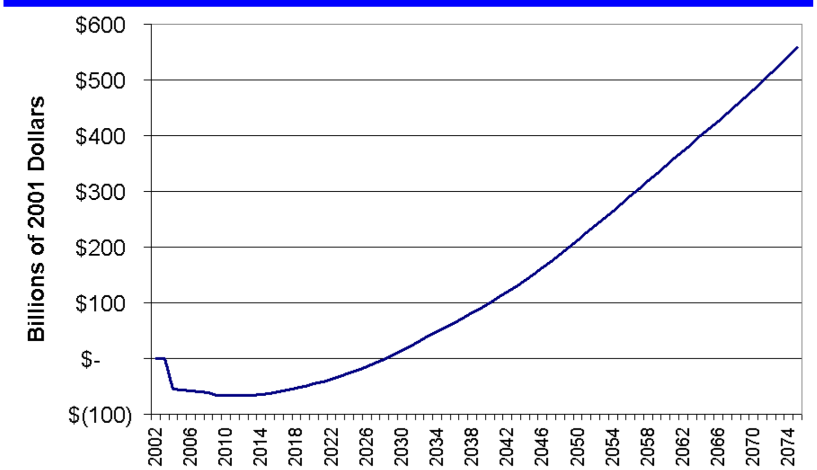
Assuming 100 percent participation in the personal accounts, Reform Model 3 would have a net positive impact on the federal cash operations by 2032, with positive gains increasing throughout the valuation period, and reaching $588 Billion annually (in 2001 dollars) by 2075. The largest negative impacts on the federal budget would be $100 Billion in in 2012-2013.

Reform Model 3's Effect on Total Government Cash Flow: 100 Percent Participation



Assuming 0 percent participation in personal accounts, eventual improvements in the net annual cash budget would grow to approximately $499 billion (in 2001 dollars) by 2075. Though eventual improvements would be smaller by the end of the valuation period, such improvements would exist throughout the valuation period.

Reform Model 3's Effect on Total Government Cash Flow 66% Participation



Assuming 67 percent participation, the gain would be $558 billion (in 2001 dollars) by 2075 with positive gains beginning in 2029.

<u>(COMMISSION DECISION: SHOW 100% or 2/3 PARTICIPATION RATE?)</u>

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.[36] 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

[36] 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. For example, the income and resource tests used to determine SSI eligibility and benefit amounts should be reassessed. The program currently allows individual recipients to receive up to $20 of general monthly income such as Social Security benefits, and $2,000 in resources without affecting their SSI eligibility or benefit amounts.[37] The income exclusion has not changed since SSI was implemented in 1974. The resource exclusion was increased in 1984 from its original level of $1,500 but has not changed since. Additionally, today some 60 percent of aged SSI beneficiaries receive some Social Security income. Under a Social Security reform plan that involves personal retirement accounts, it would be necessary to examine whether these income and resource limits remain appropriate.

[37] Couples in which both members are eligible for SSI can exclude $30 in income and $3,000 in resources. For individuals and couples, a more generous income disregard applies to earned income, but very few aged SSI beneficiaries have earned income.

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.

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.