PART III

SPECIFIC OPTIONS FOR SOCIAL SECURITY

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CHART 40

The Larger the Program, the Less Support There is for Cutting It

- The choices are politically very difficult.

- Most people, if asked to name quickly the programs they would be willing to cut, say “foreign aid.” *Yet foreign aid equals less than 1 percent of the annual budget*, and costs about $9 billion a year.

- When asked whether they would support cutting the two largest entitlement programs — Social Security and Medicare — most people reject these options.

The Larger the Program, the Less Support There is for Cutting It

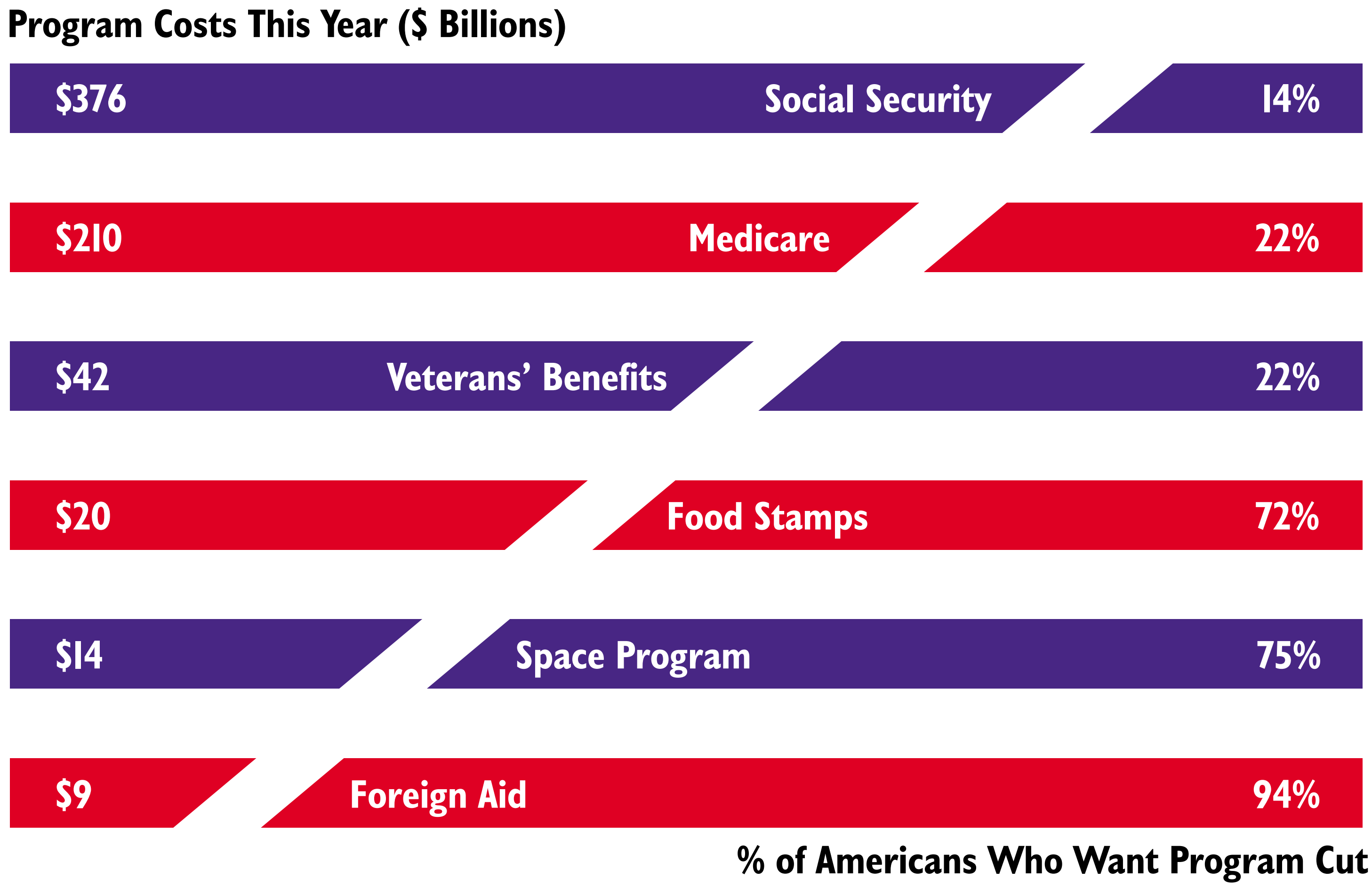

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CHART 41

Percentage of Elderly in Poverty Has Fallen in Recent Decades

- Arguably, Social Security is the most popular and successful government program. It is responsible for keeping millions of elderly Americans out of poverty.

- Indeed, the reduction in poverty rates among the elderly is due in large part to Social Security.

- Not so many years ago, to be old in America was to be poor. That is no longer true. Children, instead, are now the most likely age group to experience poverty.

Percentage of Elderly in Poverty Has Fallen in Recent Decades

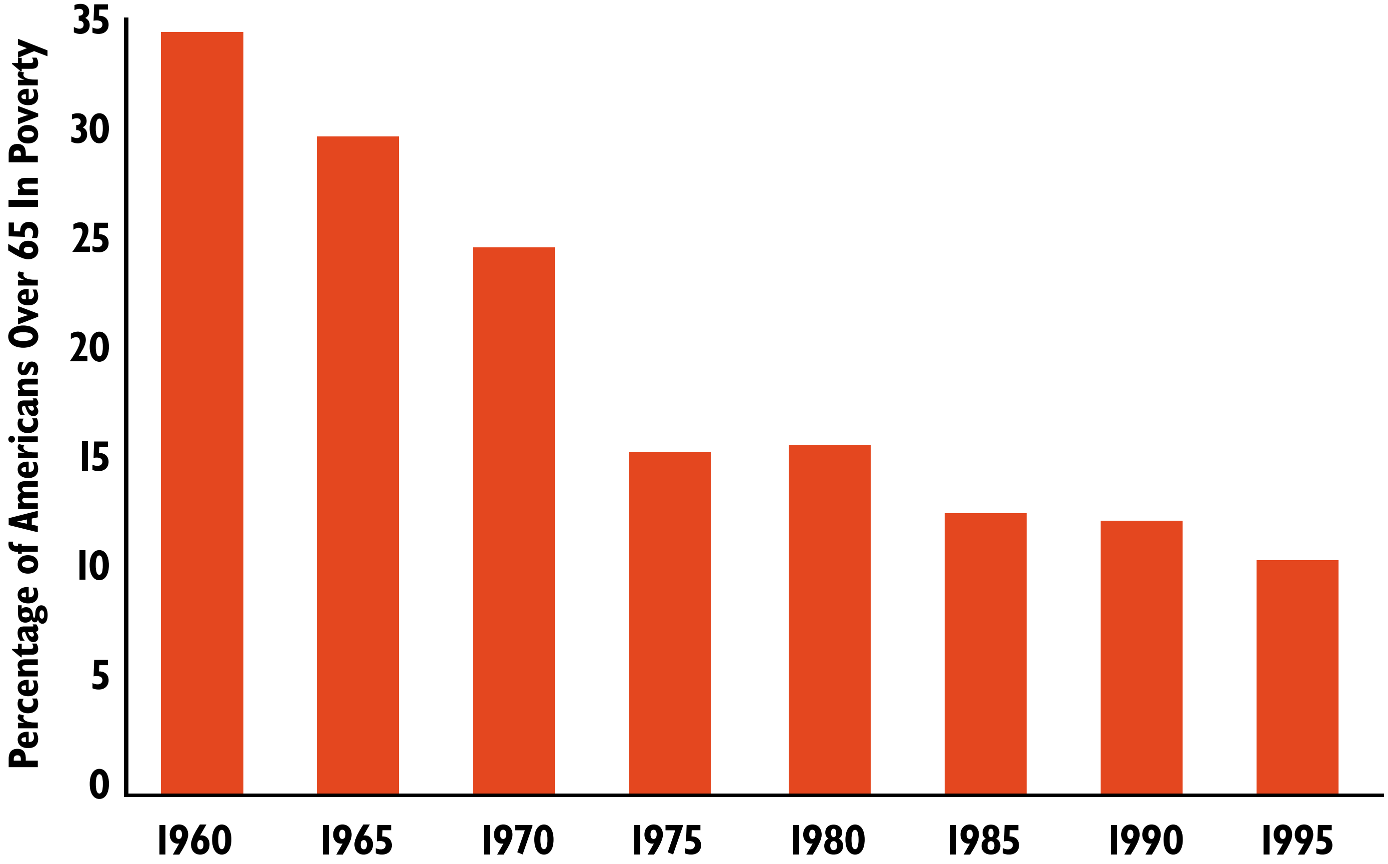

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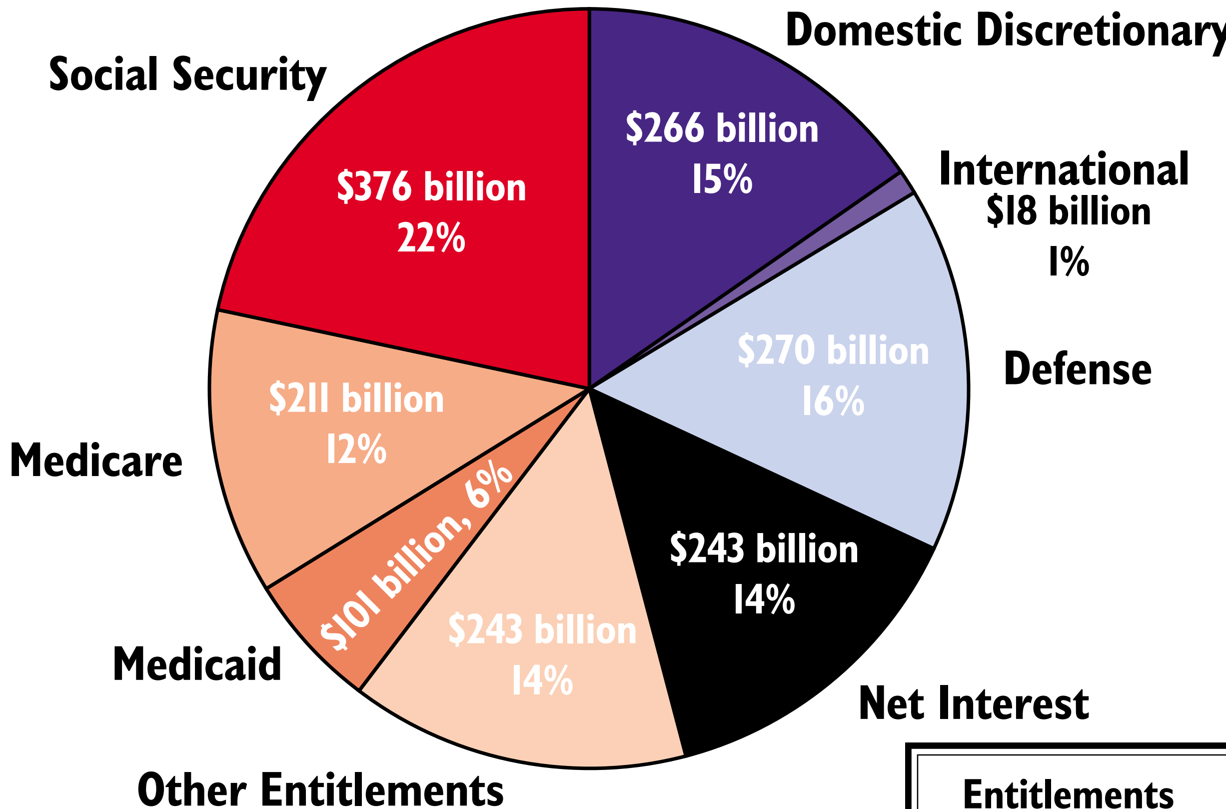
CHART 42

Composition of 1998 Federal Government Spending (Total Outlays: $1.652 trillion)

- Entitlement spending consumes roughly half of the federal budget. Counting net interest, so-called "mandatory" spending accounts for two-thirds.

Composition of 1998 Federal Government Spending
(Total Outlays: $1.652 trillion)



Entitlements	54%
Interest	14%
Discretionary	32%

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CHART 43

• More than 80 percent of entitlement spending goes to programs that are intended for the elderly. For every $9 the federal government spends for the elderly, it spends $1 for children and youth. Even adding in state and local government funding, the ratio of public spending favors seniors over children by $3 to $1.

• Therefore, to make the federal budget sustainable when the baby boom generation retires, we have to look at these largest, age-related programs.

• **Medicare** is the senior program in the most financial difficulty. Logic suggests tackling it first. There are several reasons, however, why this may not happen:

> For one thing, a substantial set of changes and program reductions, enacted in 1997, is in the throes of implementation, which is not going smoothly. In fact, Congress in 1998 moderated some of the 1997 reductions to provide temporary relief. Many caution that the 1997 round of reductions should be fully implemented and given a chance to work before hitting the program with another set of reforms.
>
> It is not yet clear the extent of savings that will be realized from the 1997 reforms. One of the chief changes was to allow more Medicare beneficiaries a choice of health care plans, including HMOs, PPOs, POSs, and other managed care systems. However, pricing changes also included in the 1997 legislation led a number of managed care providers to decline Medicare involvement in areas where they previously had competed.
>
> The entire medical sector of the economy is undergoing unsettling major systemic change. Most working-age Americans are now insured through managed care providers, and the economics of the medical market are shifting. Breakthroughs in gene technology, micro-surgery and pharmaceuticals are bringing huge changes in medical services and the way they are delivered. This radically changing landscape makes it difficult to know with any certainty what impact changes to Medicare will have.
>
> A Bipartisan Commission on Medicare Reform failed to reach consensus on how the program should be reformed. Because Medicare is not “ripe” for reform in 1999, many policy and political leaders argree that the “easy” problem, Social Security, should come first.

Social Security does not have the unknown factors that make Medicare so difficult to manage or predict. The choices available to deal with the Social Security problem are fairly straight forward, and the results of these choices are knowable within a narrow range of certainty.

Over 80% of Current Entitlement Spending Is For Retirement and Health Care Programs (Fiscal Year 1998)

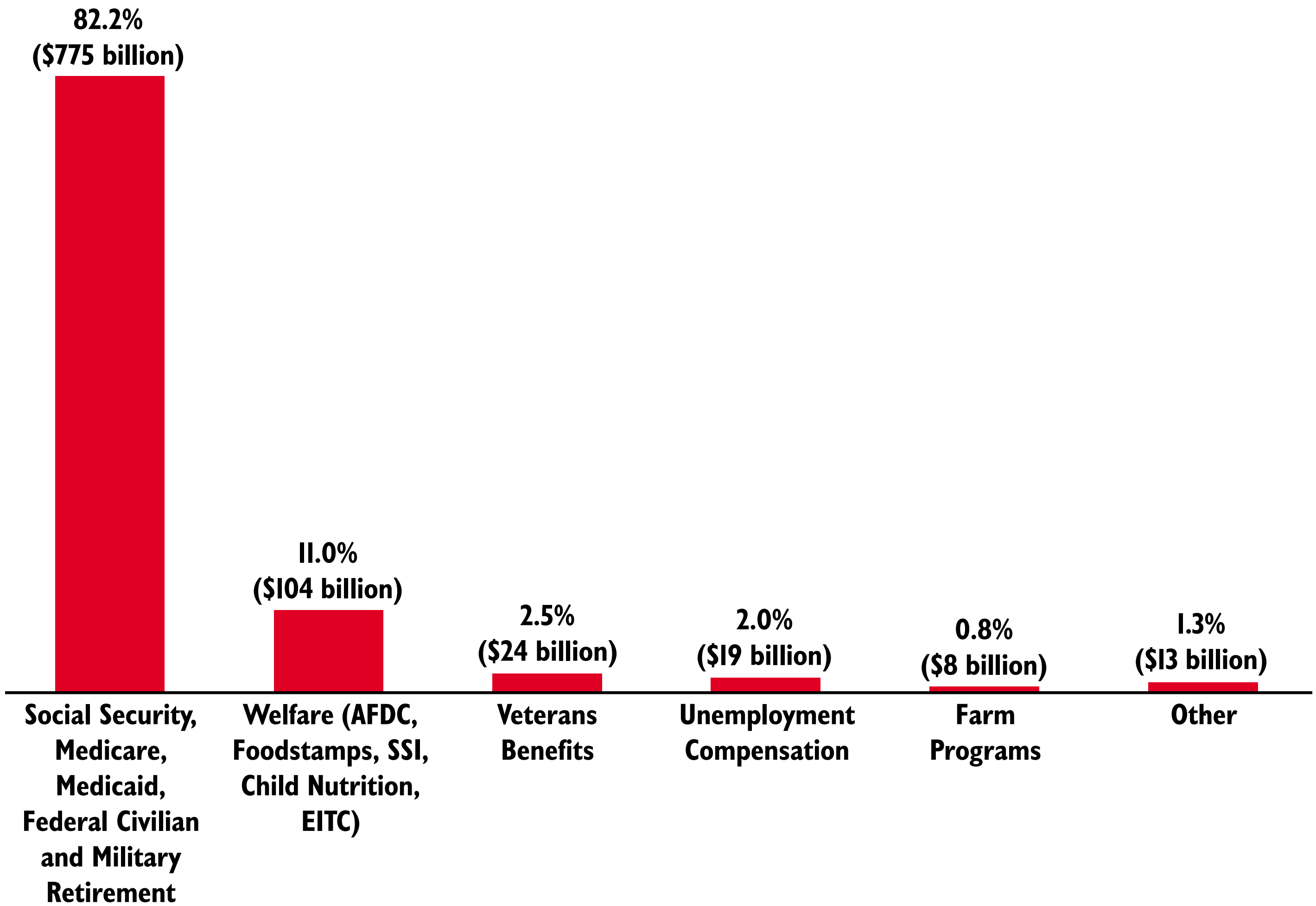

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CHART 44

Options for Social Security

- We know we cannot borrow the funds required to sustain the Social Security program indefinitely. The aging of America means that the costs will grow faster than revenues throughout the coming century. So borrowing our way through the coming crisis is not a viable option.

- Neither is simply doing nothing in hopes that something will turn up. If nothing is done before the problems in Social Security reach crisis proportions, it will be too late for gradual, reasonable and equitable adjustments, and only abrupt and painful choices will be possible.

- The convetional choices of raising revenues or reducing benefits does not seem very appealing, particularly for younger workers. Some therefore suggest looking "outside the box" for a solution.

Options for Social Security

- Increase revenues
- Reduce benefits
- Go “outside the box”

NON-STARTERS

- Borrow the money
- Wait until the crisis is at hand

CHART 45

Payroll Tax Rates Have Grown Steadily

One conventional option is raising payroll tax rates.

- Payroll taxes have risen substantially since Social Security's enactment in the 1930s. The combined employer -employee payroll tax started at 2 percent of a workers first $3,000 of earnings, or *$60 for an entire year* for those with highest incomes. Most people paid much less.

- Gradually, over the years, as the number of beneficiaries grew relative to the number of workers, and as benefits were made more generous, the payroll tax was increased.

- Today, the rate stands at 12.4 percent for the Old Age, Survivors and Disability Insurance (OASDI) programs that provide retirement and disability benefits to workers, their spouses and survivors. It is levied on the first $72,600 of annual earnings, and this dollar level is indexed to the level of average wages.

- Starting in 1965, when Medicare was enacted, an additional payroll tax for that program was levied. The Medicare portion of payroll tax is 2.9 percent. It applies to all covered earnings, with no ceiling.

- No further increases in the payroll tax rate are currently scheduled.

Payroll Tax Rates Have Grown Steadily

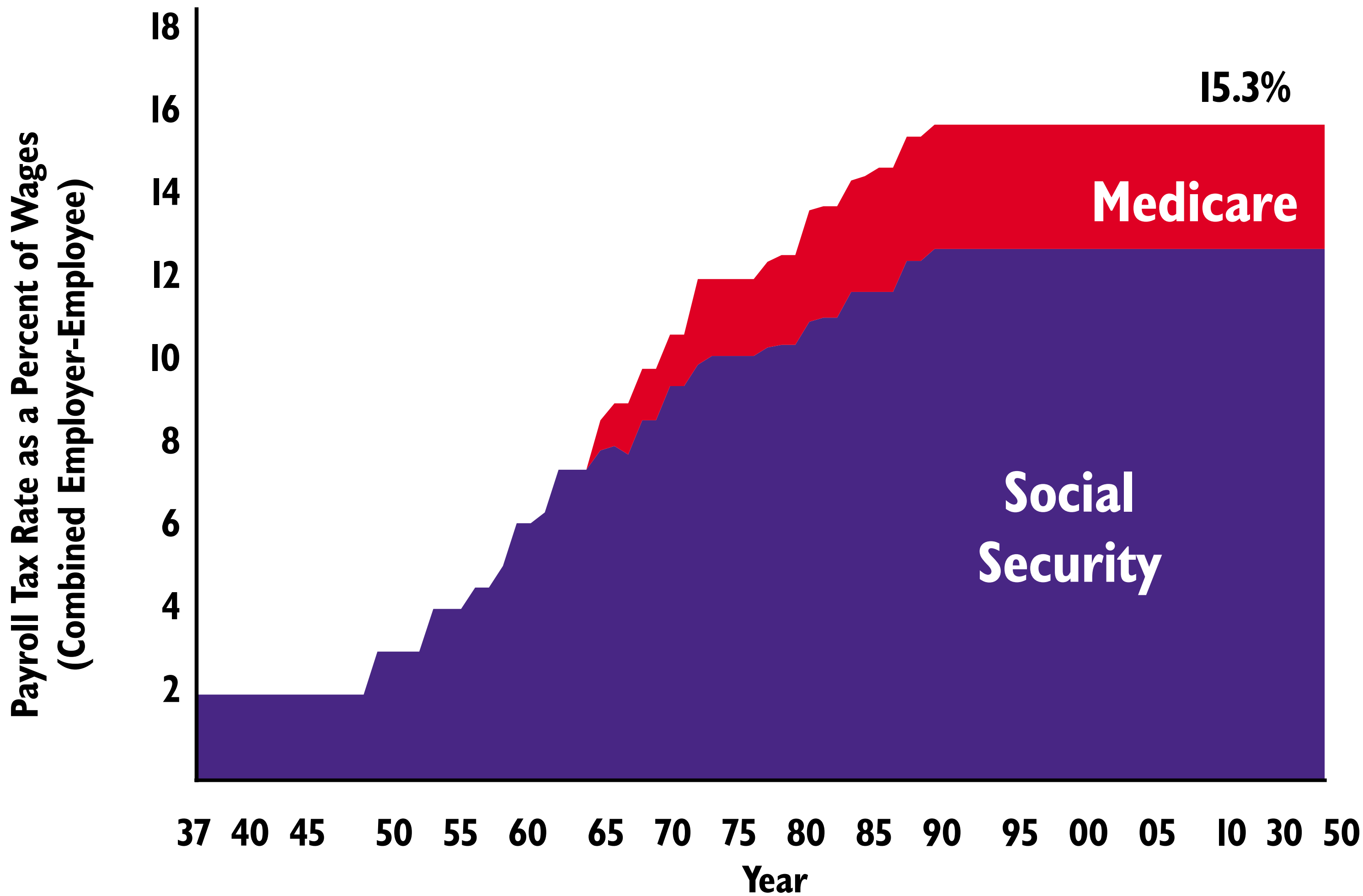

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CHART 46-A — Option:

Raise the Payroll Tax Rate 1% Each On Employer and Employee

- One option would be to increase the Social Security tax 1 percent on employers and employees, for a 2 percent increase overall. Some experts claim the entire Social Security problem could be solved with a 2.2 percent increase in the payroll tax, so adding 1 percent to employers and employees would come close to closing the gap.

- However, the 2.2 percent figure is extremely misleading. That figure comes from a calculation of what is needed today to close the long-term 75 year actuarial deficit. It assumes that surpluses piled up in the next few years would then be used in the future to finance benefits.

- Under this methodology, a 2.2 percent tax rate increase now would put enough bonds into the program's reserves, so that the very last bond and last penny of interest would be used 75 years from now. In year 76, the program would face a huge shortfall, so large that income would be sufficient to finance only about three-quarters of promised benefits.

Raise the Payroll Tax Rate 1% Each On Employer and Employee

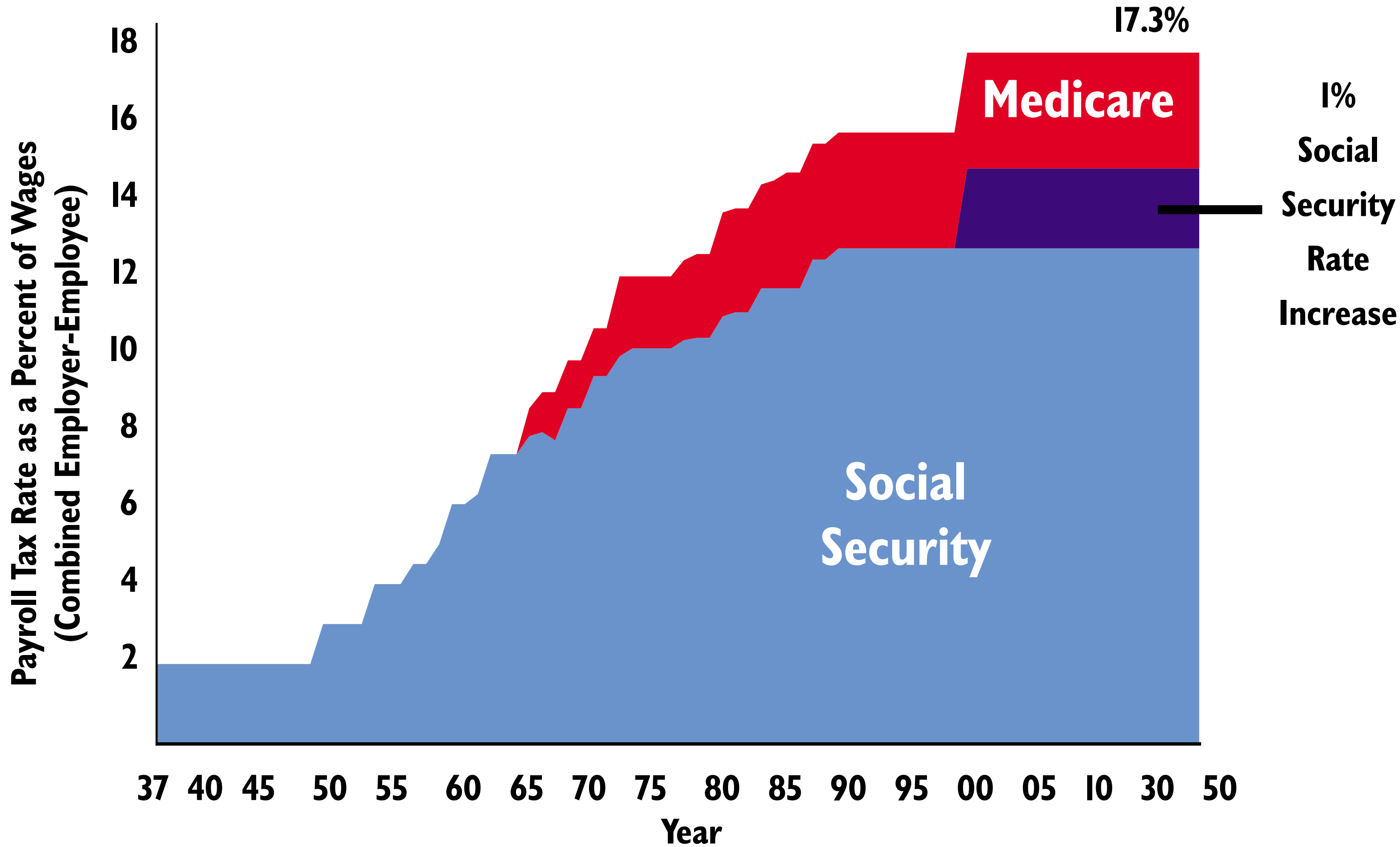

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CHART 46-B — Option:

The Myth of the 2.2 Percent Solution

- The following chart shows why a 2.2 percent tax increase is insufficient:

Annual OASDI Operating Balance as a Percentage of Payroll

Year	Current Law	With Additional 2.2%
2000	1.86	4.06
2010	0.84	3.04
2020	-2.12	0.08
2030	-4.62	-2.42
2040	-5.00	-2.80
2050	-5.06	-2.86
2060	-5.77	-3.57
2070	-6.29	-4.09

- Even with a 2.2 percent increase, the program would experience an additional 2.42 percent of payroll shortfall by 2030, and a full 4 percent shortfall by 2070.

The Myth of the 2.2 Percent Solution

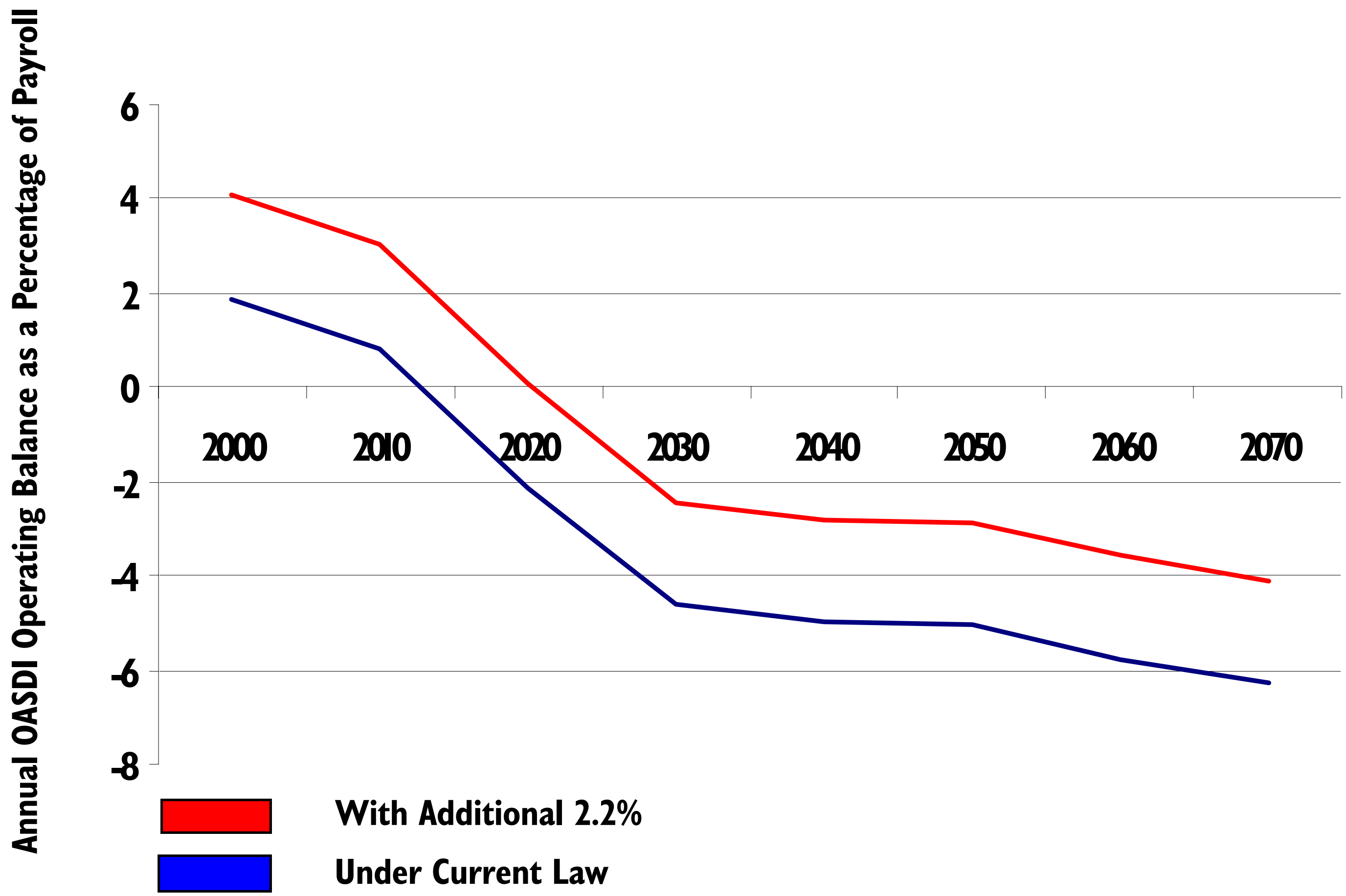

CHART 47 — Option:

Raise The Rate As Needed To Pay Benefits

- So, how much would it take to solve the problem entirely through new revenues? The Social Security Trustees report that it could cost, under the high-cost scenario, between 20 and 24 percent of payroll. Medicare payroll taxes would be added on top of this figure.

- That is one way to solve the problem, of course. But it is important to keep in mind that **payroll taxes are the largest federal tax paid by most working age Americans.**

  The payroll tax for a median-income family of four was about half its income tax in 1962.

  By 1982, the two taxes were about the same size.

  By 1995, the median-income family's payroll tax was 150 percent as large as its income tax.

- The payroll tax is a flat tax.

  Some people think flat taxes are fair; after all, everyone pays the same rate.

  But in thinking about raising payroll tax rates, it is important to remember that, unlike the progressive income tax (which attempts to relate the tax burden to people's ability to pay), the payroll tax is blind: all pay the same.

  It does not take into account whether the worker who earns $35,000 a year has a spouse who earns twice as much, a spouse who stays home to care for a disabled child with high medical costs, or no spouse at all. It does not care whether the worker has 15 dependents to feed or lives alone and eats out.

Option: Raise The Rate As Needed To Pay Benefits

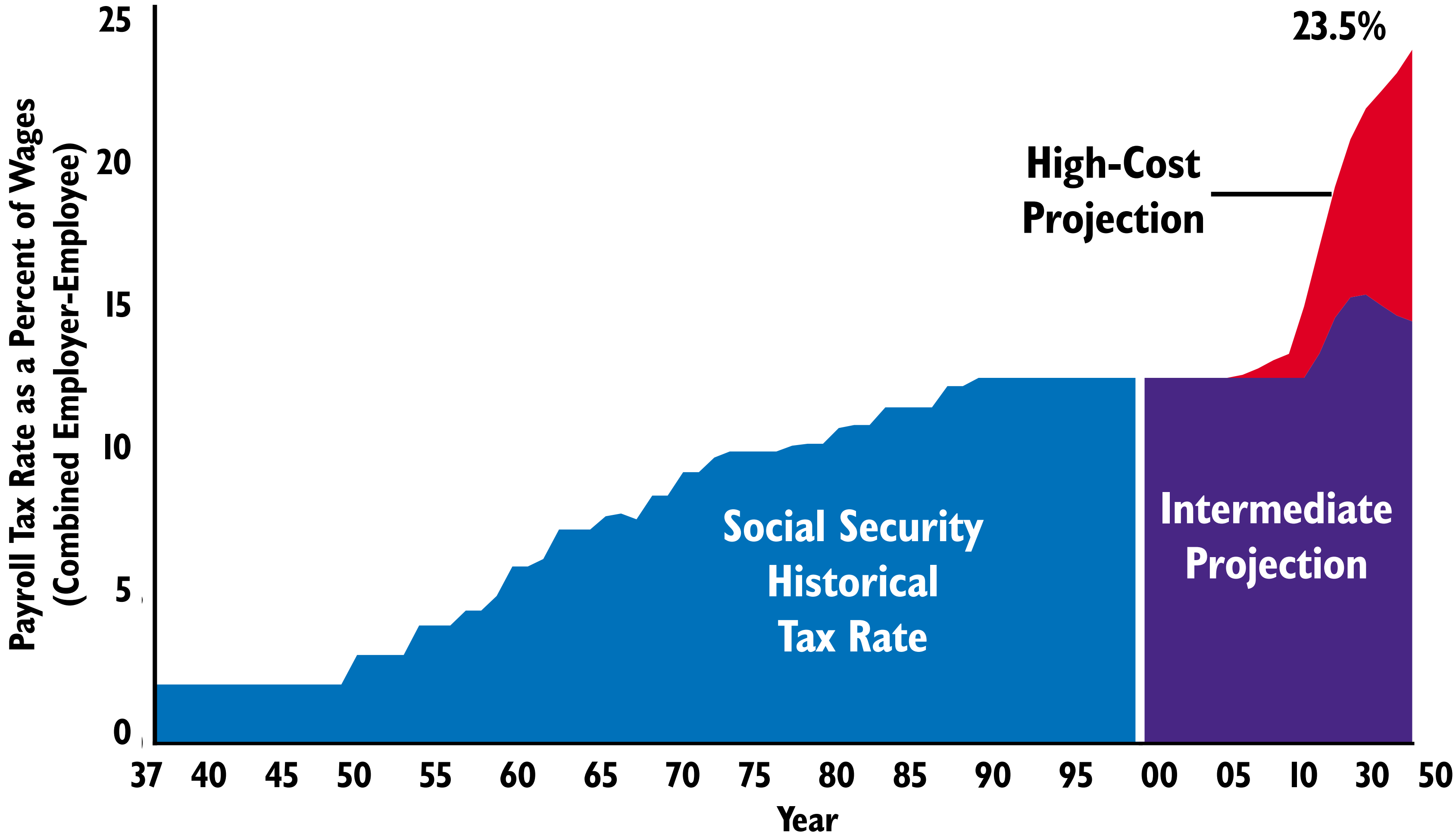

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CHART 48:

Maximum Taxable Earnings Subject to Payroll Tax

- Historically, the wage base has increased along with the tax rate. It was set at $3,000 for several decades and then it gradually increased, until it reached $13,200 in 1974. Wage indexing was implimented in 1975. By 1985, the wage base had climbed to $39,600.

- Today, rather than rely on Congress to enact ad hoc wage base changes, the base is *indexed to average wages* and rises as wages rise.

- In 1999, the payroll tax base for Social Security was $72,600. (For Medicare, there has been no cap since 1994 on how much of one's annual earnings are subject to the 2.9 percent payroll tax.)

Maximum Taxable Earnings Subject to Payroll Tax

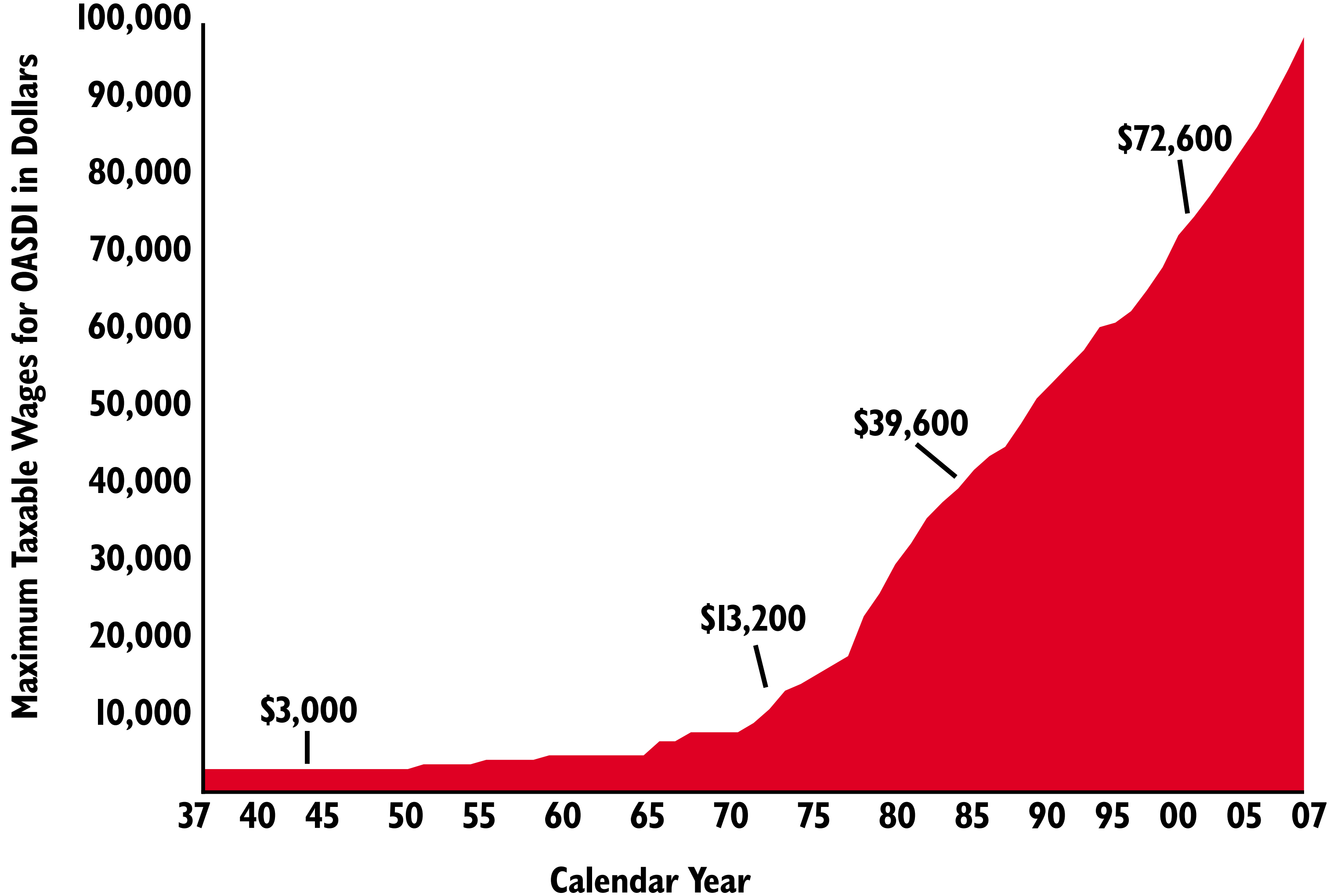

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CHART 49 — Option:

Eliminate the Cap

- Eliminating the cap would bring in much more revenue and would impact only upper-income workers.

- However, there are several drawbacks to this approach.

  Benefits are determined by taxable earnings. If the cap were eliminated, benefits in the future would grow to astro nomical amounts. The benefit formula could be changed, of course, so this would not happen, but that would break with the program's historic goal of providing individual equity along with social adequacy.

  If benefits are permitted to grow, there still would be a lousy return on the money paid in. Even so, benefits would be staggering in absolute terms. Ultimately, the effect would be to increase the cost of Social Security so that *six-figure monthly checks could be mailed to the likes of Bill Gates, Warren Buffett, and Ross Perot.*

  Tax avoidance is a time-honored American tradition, and eliminating the payroll tax cap would bring it back with a vengeance. High tax rates in the 1970s taught us that self-employed workers, as well as others, can be extremely creative in finding ways to recharacterize their incomes and restructure their business to convert as much as possible of their "earned income" into "income from investment."

- The self-employed would be particularly affected. While self-employment earnings comprise only 7 percent of all covered earnings, they comprise nearly 20 percent of earnings above $100,000. Much of this income represents a return on capital invested in small businesses.

Option: Eliminate the Cap

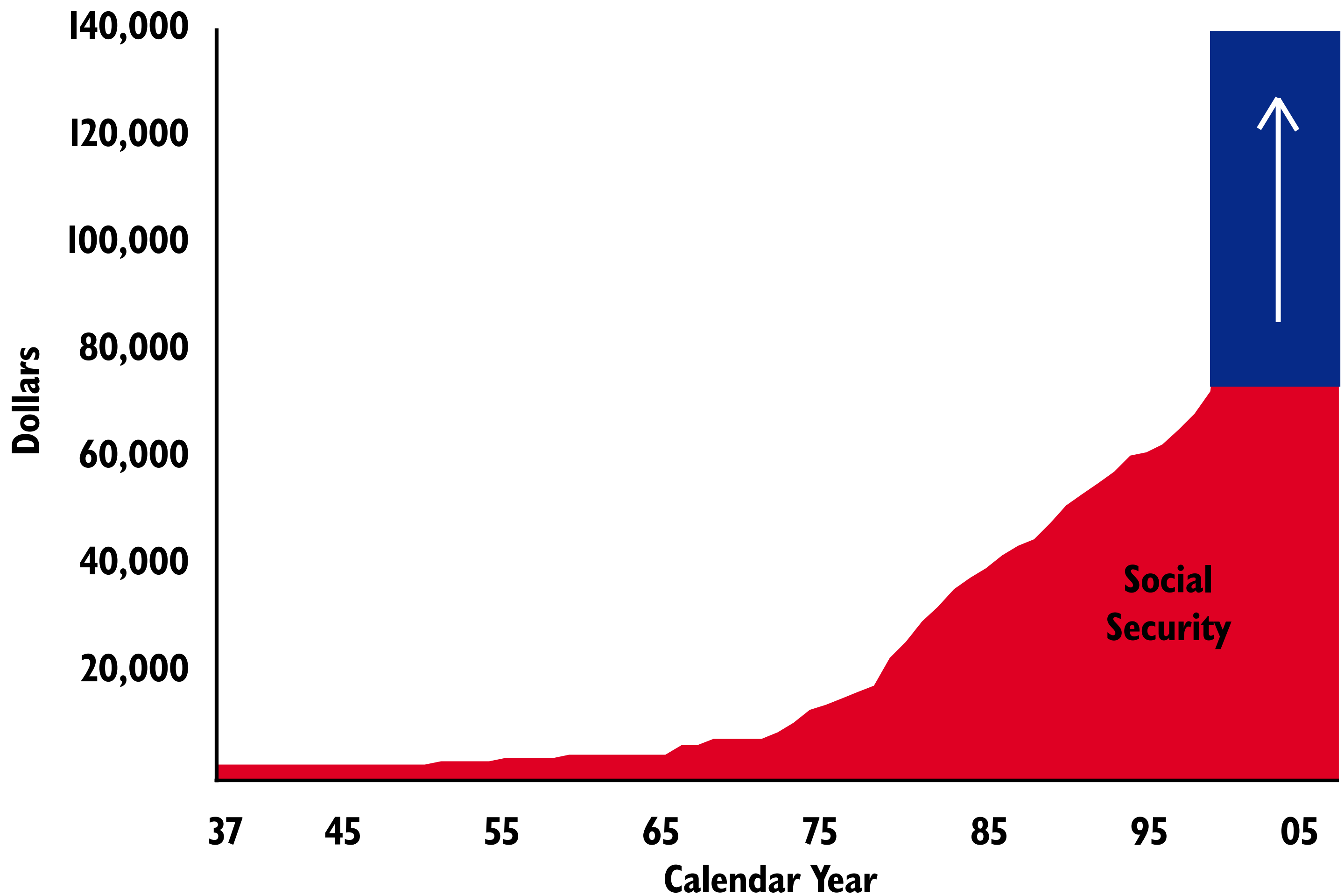

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CHART 50 — Option:

Increase The Cap To 90% Of Covered Earnings

- Another option is to raise the wage base to 90 percent of earnings in covered employment.

- This would put the payroll tax base at about $100,000 in the year 2000, and then it would be indexed to stay at the 90 percent level thereafter.

- Raising the cap to 90 percent of covered earnings and holding it to that level thereafter would solve about one-fifth of Social Security's long-term trust fund deficit.

- Raising the cap would cause many of the same problems and economic inefficiencies as eliminating the cap, but to a lesser degree. Raising the cap very gradually by, say, a half or quarter percentage point annually, would ease the adjustment and minimize tax avoidance responses.

Option: Increase The Cap To 90% Of Covered Earnings

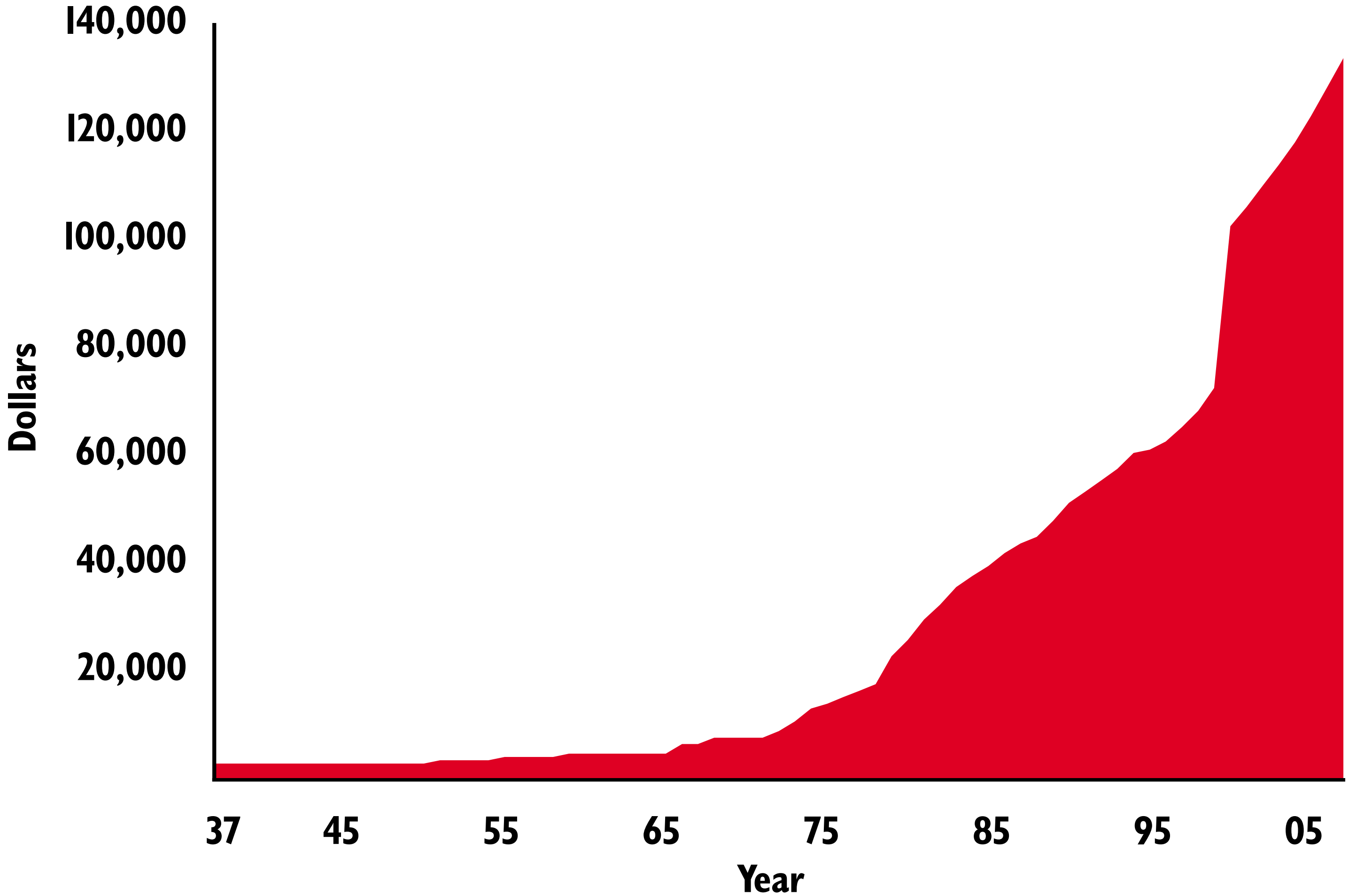

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CHART 51

Social Security Taxable Earnings As Percentage of Covered Earnings, 1937-1998

- It is sometimes suggested that returning the wage base to 90 percent of covered earnings would merely restore the "historic level." This is not true.

  Payroll taxes have *seldom* been as high as 90 percent of covered earnings. In fact, since World War II, the cap reached the 90 percent level only in 1982 and 1983.

- The average over the life of the program has been slightly less than 84 percent.

- The average over the last 50 years has been 82.6 percent.

- The average over the last 20 years has been 87.7 percent.

- Today, the cap equals about 86 percent of covered wages.

Social Security Taxable Earnings As Percentage of Covered Earnings, 1937-1998

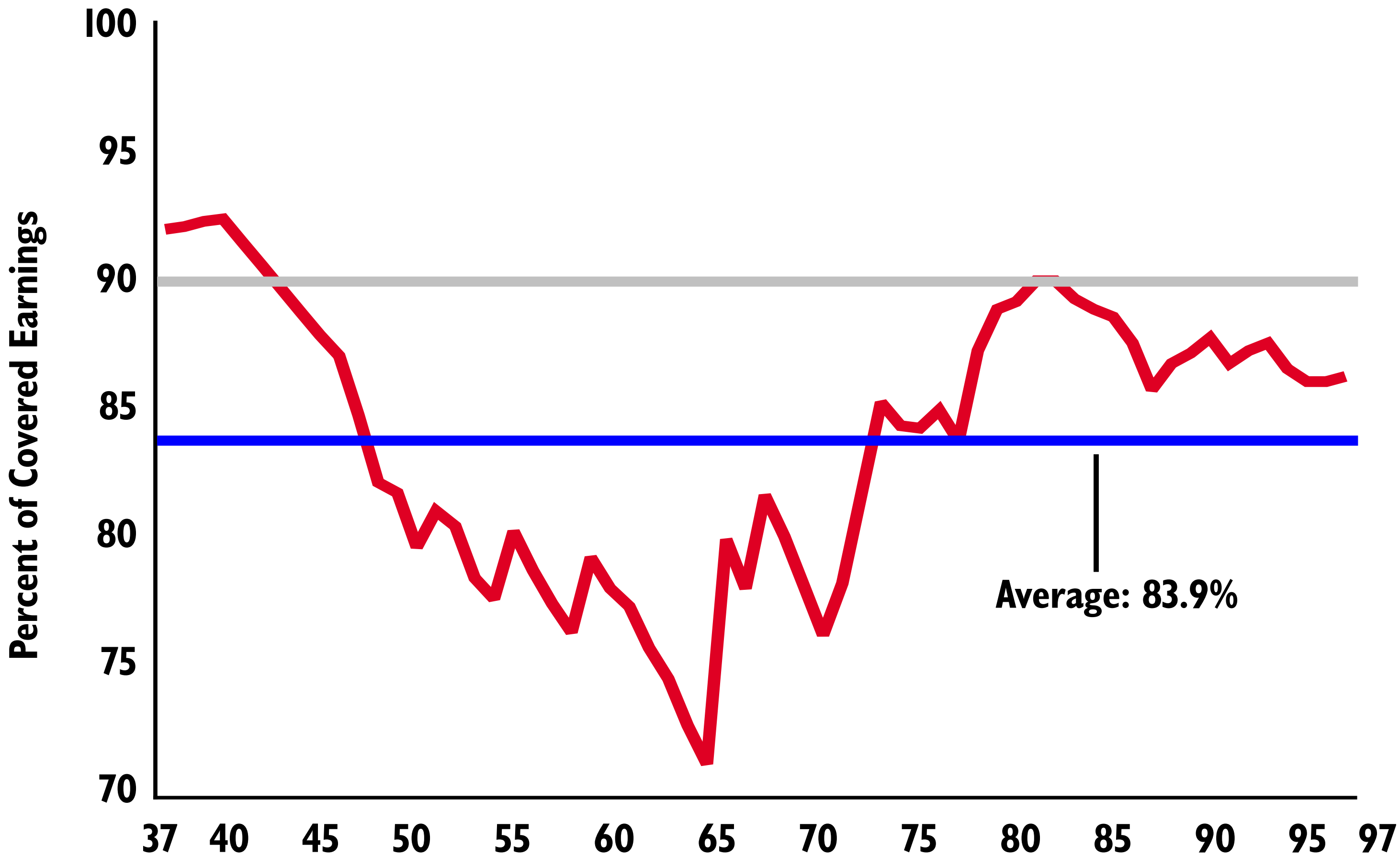

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Chart 52 — Option:

Raising Taxes on Benefits

• Another revenue option would be to make benefits received by elderly people fully subject to the federal income tax.

Under current law, beneficiaries with income of more than $25,000 if single and $32,000 if married must include up to *half* of their benefits in their taxable income. Revenues from this provision are credited to the Social Security and Disability Trust Funds.

Those with incomes of more than $34,000 if single and $44,000 if married must include *up to 85 percent* of their benefits in their taxable income. Revenues from the 85 percent increment are credited to the Medicare HI Trust Fund.

• Currently, taxation of benefits generates $9 billion for the Social Security and Disability programs each year, and another $5 billion for Medicare Part A Hospital Insurance.

• If the thresholds were eliminated and up to 85 percent of all benefits were includable in federally taxable income, amounts equal to about 0.21 percent of payroll would be generated.

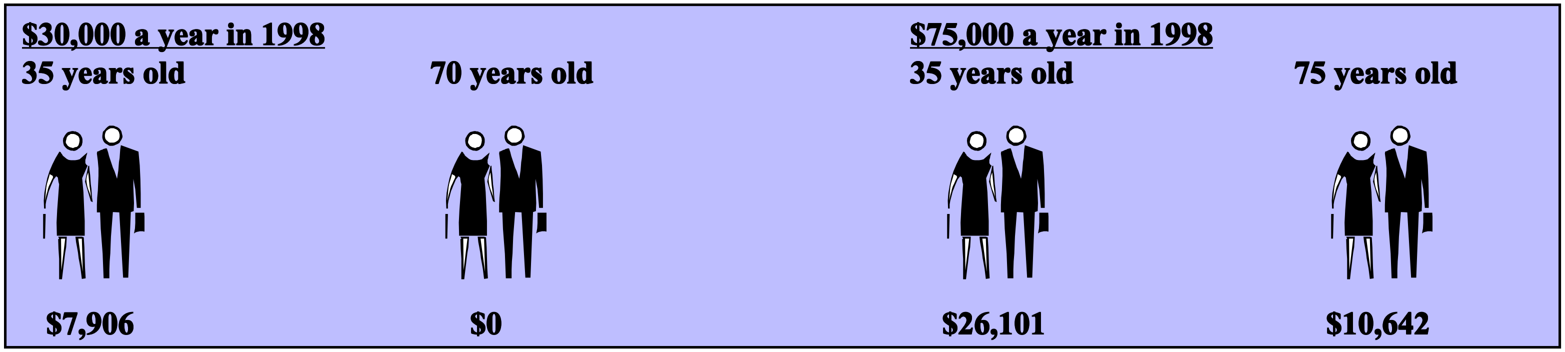
• Unlike an explicit means test, for which a new administrative structure would have to be established, increased taxation of benefits could be accomplished within the federal income tax system currently in place.

• Yes, it is true that taxing benefits more would worsen workers' return on the amounts they paid in over the years. But the deal would be worsened only for those who could afford it.

• Some high-income beneficiaries might gripe, but the equity argument would be against them as soon as they compared their circumstances to working-age people at their same income level.

Example: two married couples residing in Fairfax, Virginia, in 1998.

• One is a 35-year-old working couple with one small child, $30,000 in self-employment income, and a condo worth $100,000. Their bill for the “big four” taxes — federal and state income taxes, federal payroll taxes, and local real estate taxes — comes to **$7,906**.



• Now consider their neighbors down the hall — a 70-year-old retired couple with the same $30,000 income, split evenly between Social Security benefits and taxable investment returns, and the same $100,000 condo. How much does this retired couple pay in the big four taxes? ***Nothing.***

They owe no FICA tax since none of their income comes from earnings. With their personal exemption and total exclusion for Social Security benefits, they owe no federal income tax. And they owe no state and local taxes because Fairfax County, like many jurisdictions, waives property taxes for seniors (but not the young) beneath certain income levels.

• Now imagine that the same couples have $75,000 incomes and $200,000 condos. (Assume that the retired couple gets maximum Social Security benefits and that the rest of their income is taxable investment returns.) In this example, the working couple pays **$26,101** for the big four taxes while the retired couple pays just **$10,642**. Of that, the extra 85-percent Social Security tax tier accounts for exactly $1,446.

• Although some seniors complain today that *any* of their Social Security is subject to income tax, most understand that the vast discrepancies between their burden and that of younger families with identical income and greater expenses are impossible to defend.

CHART 53 — Option:

Increase Immigration Rates

- It is sometimes suggested more immigrants would restore the population pyramid and add working-age people who contribute payroll taxes.

- Immigration peaked around 1900 both in sheer numbers of people entering the country and as a percent of the total population. It plummeted to almost nothing in the 1930s and 1940s but increased sharply in the 1980s and 1990s.

- Today the number of immigrants is higher than at the beginning of the century. However, our population is much larger today (275 million) than in 1990 (75 million), so the immigration *rate* as a percentage of total population is lower than it was in 1900.

- Social Security mid-range projections assume immigration will level off at 900,000 annually, while the low-cost scenario assumes that it will level off at 1,150,000 annually. (The high-cost scenario assumes immigration will decline and stabilize at 750,000 annually.)

- Because most people immigrate at relatively young ages and have many working years ahead of them in the U.S., each group of 1 million immigrants reduces the long-range Social Security imbalance by 0.6 percent of payroll.

- This means immigration would have to increase many times over, and remain at a high level indefinitely, to finance retirement income and health insurance programs. To completely solve the Social Security problem through immigra tion alone would require increasing immigration by 5 or 6 times the current rates.

Option: Increase Immigration Rates

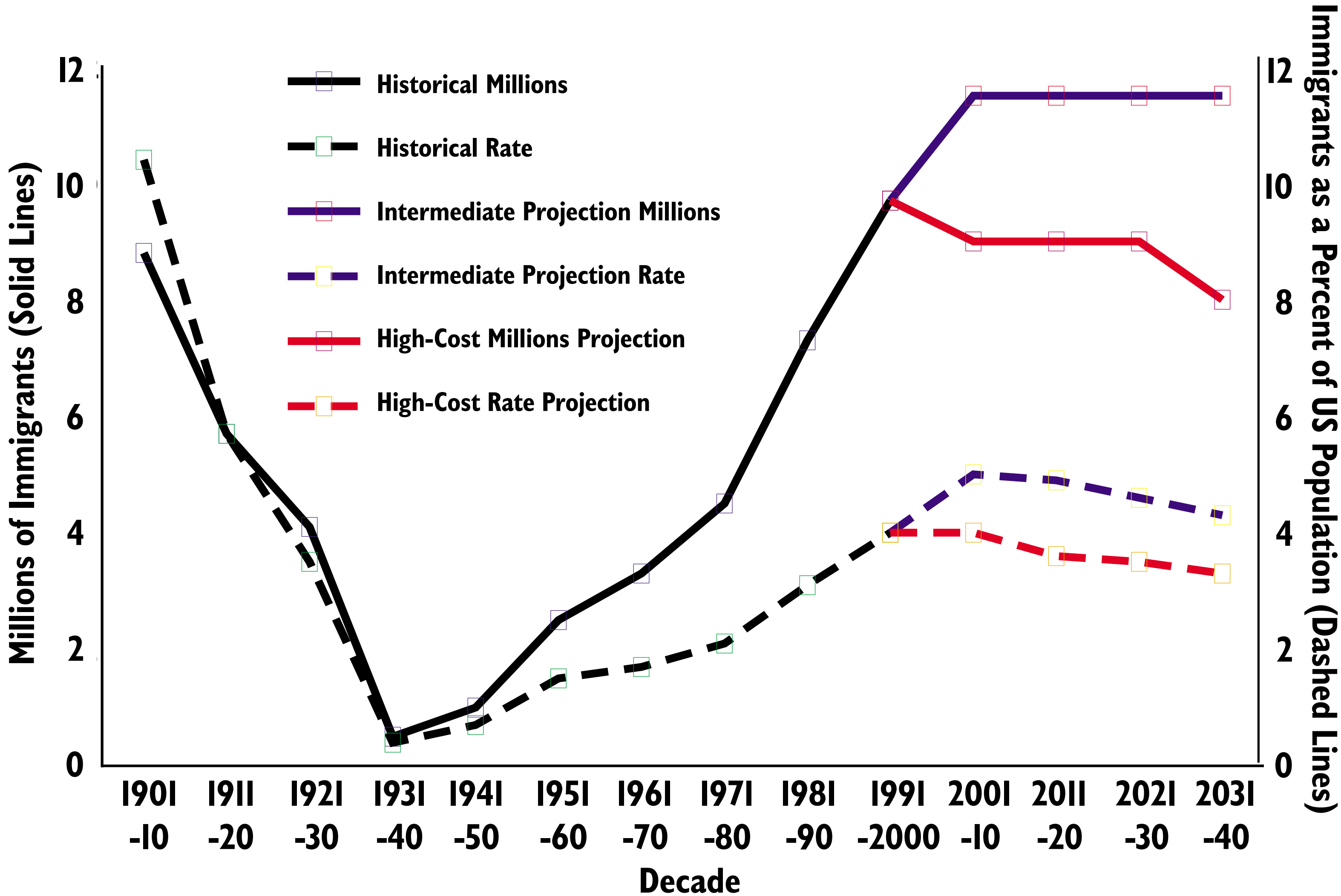


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CHART 54

Present Social Security Law:
Full Benefits At Age 67, Early Eligibility Benefits At Age 62

- Under present law, the age at which workers can claim full benefits is scheduled to begin increasing gradually for everyone born after 1937.

  For people born between 1943 and 1955, the age for full benefits will be age 66.

  For people born after 1960, the age for full benefits will be age 67.

- The age at which early benefits are available will remain at age 62. However, the actuarial reduction, which is designed to keep total lifetime benefits roughly constant regardless of choice of retirement age, will be commensurately greater for people claiming early benefits.

Present Social Security Law:
Full Benefits At Age 67, Early Eligibility Benefits At Age 62

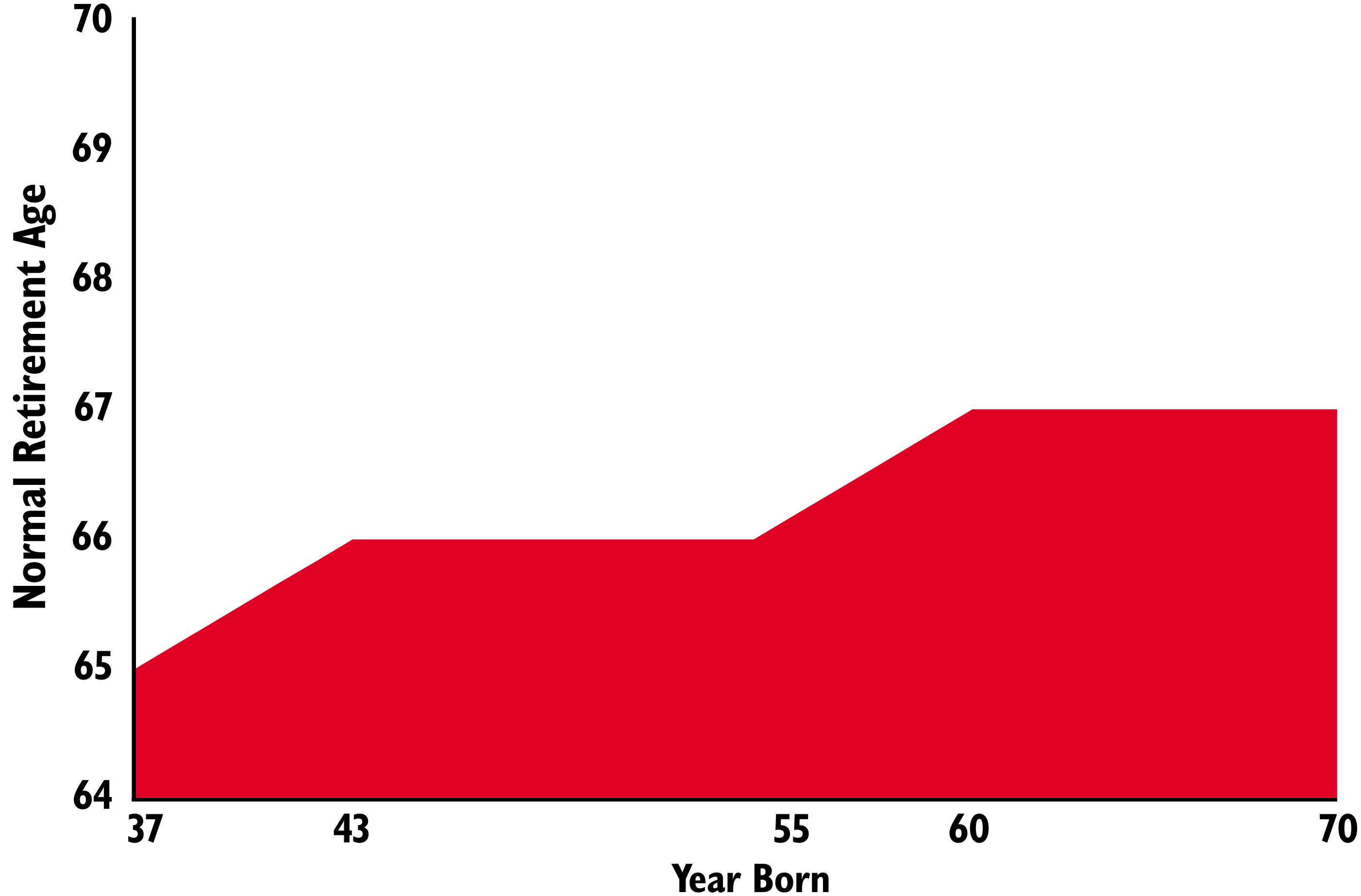

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CHART 55: Option

Skip the Plateau

- The most modest suggestion for raising the benefit eligibility age is to skip the "plateau" that holds the full-benefit age at 66 for people born between 1943 and 1955.

- Instead, the eligibility age would continue rising, and would reach age 67 for anyone born in 1949 or after.

- While that modest step would help the program's finances a little, it would not save much money over the long haul.

Option: Skip the Plateau

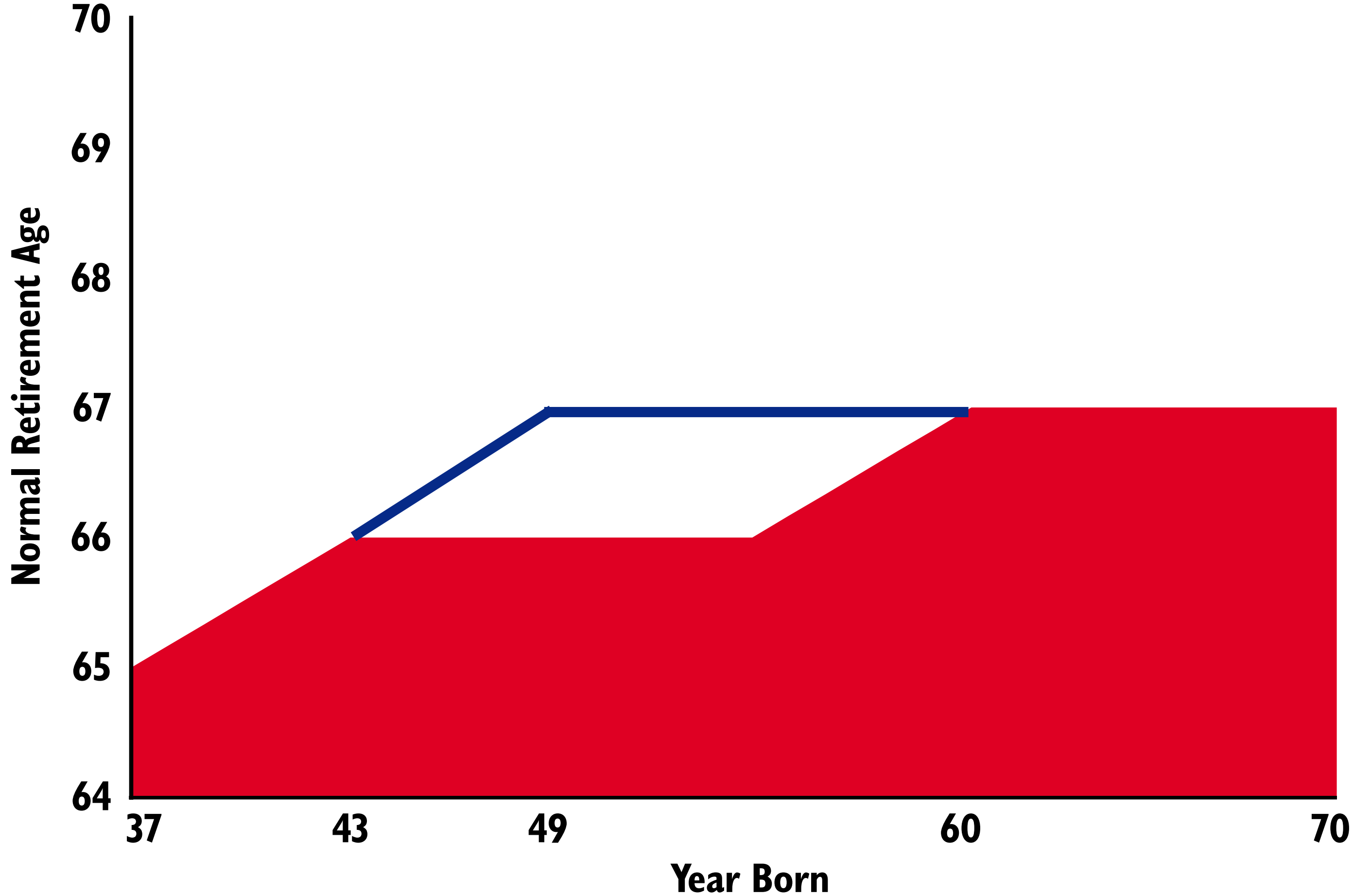

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CHART 56: Option

Skip the Plateau, Raise Age to 68, 69, or 70

- Raising the full benefit age to 68, 69, or 70 would be a much more powerful policy for reducing long-term benefit costs.

- Life expectancy has gone up much more than 5 years since the program was established and the full benefit age was set at 65.

- Increasing the age for full benefits beyond age 65 would track with this increased longevity. People would receive benefits, on average, for the same years or longer as people who retired in the 1950s, 1960s, and even the 1970s.

- Raising the early eligibility age would not reduce benefit costs since early benefits are reduced so that the amount paid, on average, to a person is the same as if they waited until the full benefit age. Raising the early eligibility age, however, would encourage people to remain in the workforce until they reach the early eligibility age or older. When the workforce stops growing in the 2020s, this might be a way to augment the overall numbers of people available for work.

Option: Skip the Plateau, Raise Age to 68, 69, or 70

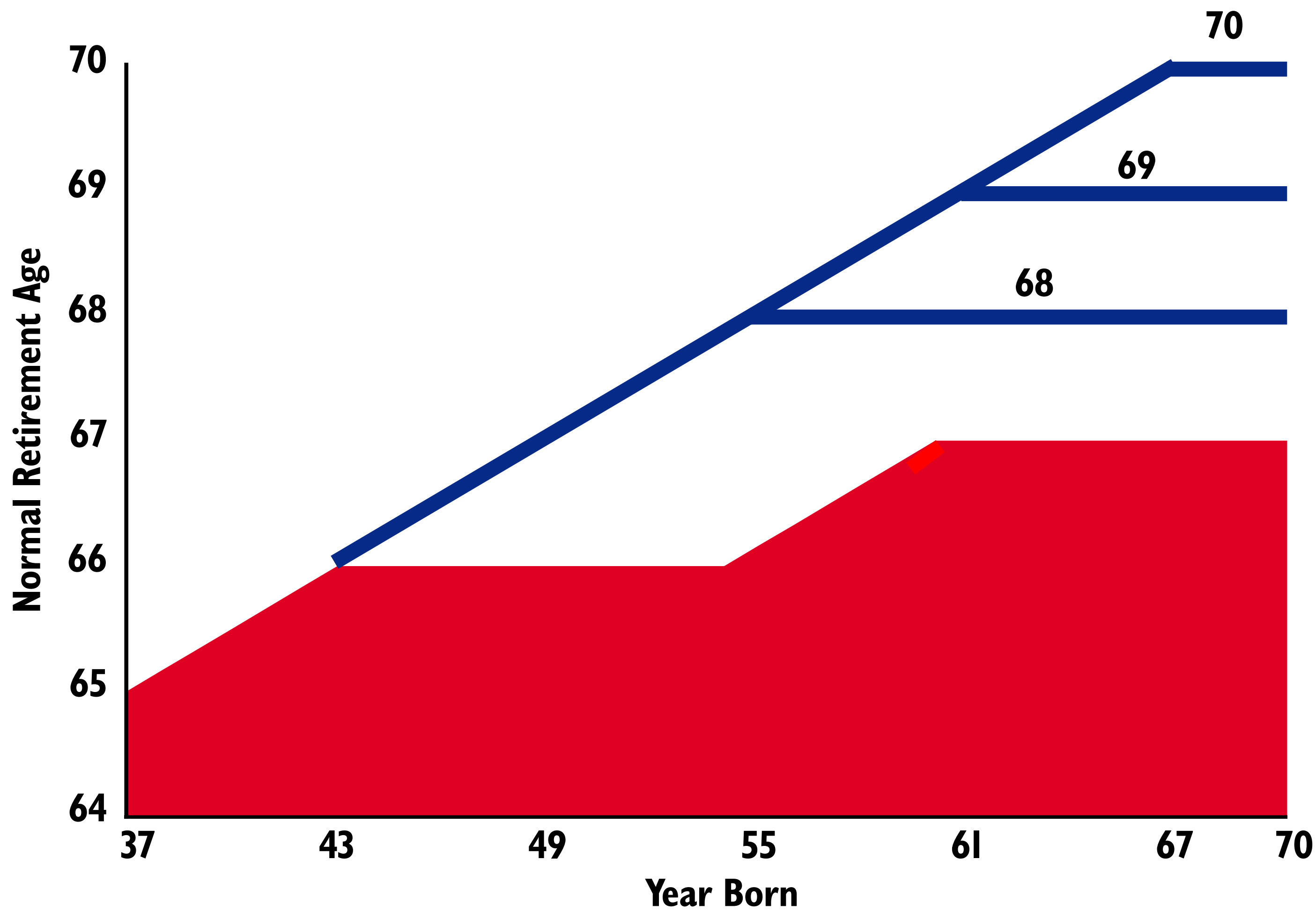

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CHART 57: Option

Change The Benefit Formula

- Another option for reducing benefits would be to explicitly reduce initial benefits for new beneficiaries.
- Benefits are calculated by using a person's lifetime earnings record, after adjusting past earnings for inflation and average real wage growth, to determine average indexed monthly earnings.
- For individuals who first become eligible for benefits in 1999, their full Social Security benefit would be the sum of:

  a) *90 percent* of the first $505 of their average indexed monthly earnings, plus

  b) *32 percent* of their average indexed monthly earnings over $505 and through $3,043, plus

  c) *15 percent* of their average indexed monthly earnings over $3,043.
- This formula for determining benefits is progressive, it replaces a greater percentage of a beneficiary's lowest earnings.
- One way to reduce benefits would be to reduce the 90/32/15 percentages by 5 percent across-the-board to 85.5/30.4/14.25 percent. This option, shown in blue, would reduce everyone's benefits, including people with low lifetime wages.
- A way to reduce benefits for people with average or high lifetime wages would be to reduce the percentages for only the top two brackets to make the formula 90/22.4/10.5 percent (shown in red).
- To make the formula still more progressive, the percentages could be reduced on the top two brackets and a fourth 5 percent bracket could be added (shown in green).
- While the last two alternatives would be more progressive and would protect benefit levels for those with the lowest earnings, they would reduce the already low rates of return for individuals with above-average earnings.
- The calculation of benefits is confusing for most people. It occurs only once, when an individual applies for benefits. That makes it a politically tempting option for reducing benefits. Many people would never realize there had been a change, espe cially if it were phased-in gradually.

Option: Change The Benefit Formula

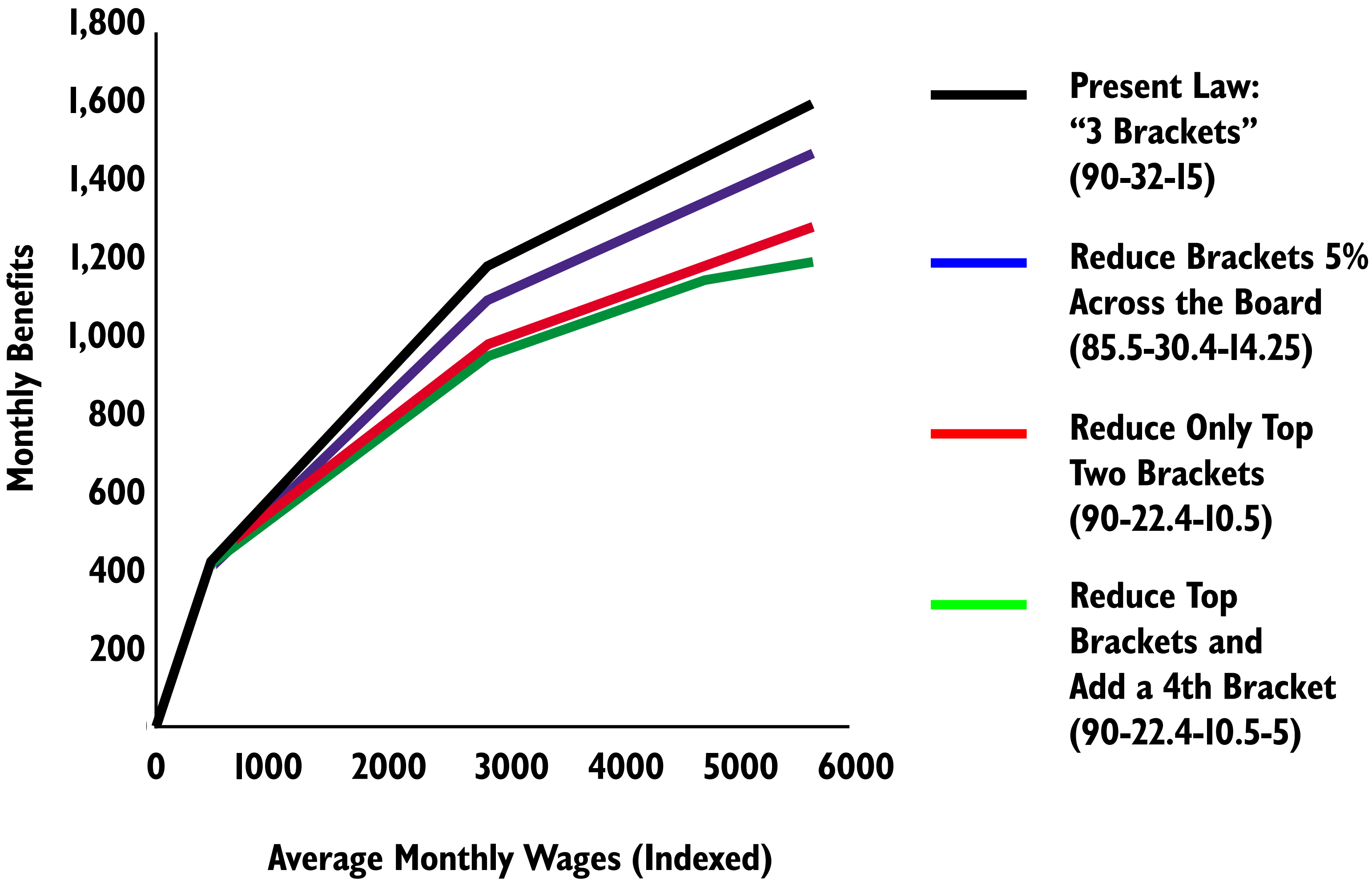

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CHART 58: Option

Affluence Test Benefits

- An option that would explicitly and transparently reduce benefits would be a reduction in Social Security and other entitlement benefits for people with above-average incomes.

- The Concord Coalition has proposed that Social Security beneficiaries with annual incomes of $50,000 to $59,999 get only 90 percent of the amount for which they would otherwise be eligible. People with earnings higher than that would have their benefits reduced by commensurately greater percentages.

- However, for people with incomes of $130,000 or higher, 15 percent of benefits would be paid. This maintains a connection with Social Security and allows for a subsequent increase in benefits if other income should decline in the future.

- All income amounts would be indexed for inflation for the purposes of affluence testing benefits.

- This proposal reduces program costs substantially and ***could solve between half and three-quarters of the long-range financing problem.***

Options: Affluence Test Benefits

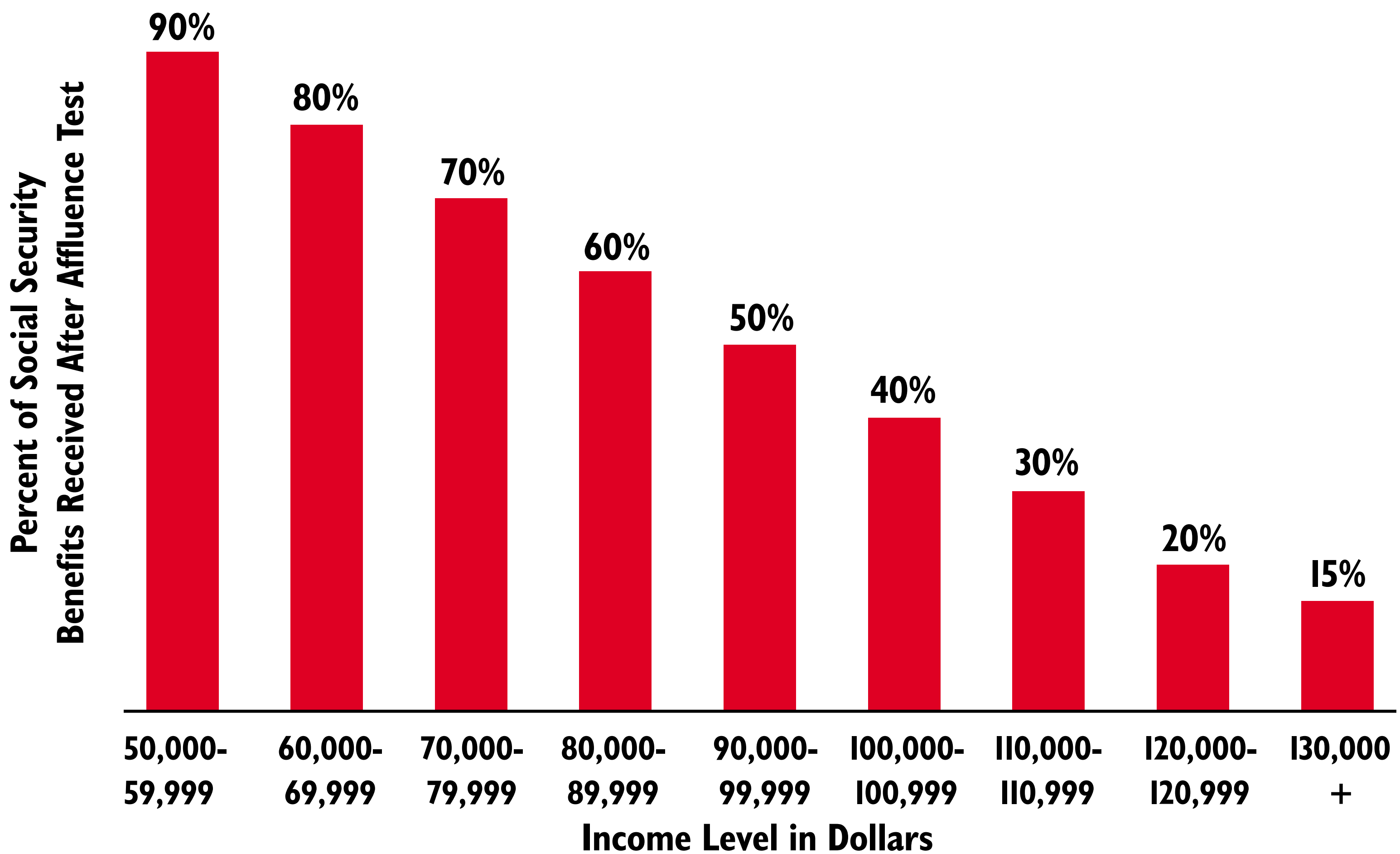

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CHART 59: Option

Reduce Cost-of-Living Adjustments By Half A Percent

- Before 1975, Congress legislated ad hoc increases in Social Security benefits from time to time. Since then, a cost-of-living adjustment (COLA) every year automatically increases Social Security benefits to keep pace with inflation.

- A commission of prominent economists reported in December 1996 that the consumer price index overstated inflation by about 1.1 percent.

- A series of improvements in the way inflation is calculated has reduced measured inflation by 0.46 percent for 1998 and subsequent years when compared to former methods. Changes being implemented in 1999 will reduce measured inflation by an additional 0.2 to 0.3 percent.

- Despite these reductions, and the currently low rate of inflation (1.6 percent in 1998), some people believe that the automatic annual increases in Social Security benefits still overcompensate for inflation. They suggest reducing the COLA by half-a-percent of stated inflation.

- Over time, this option produces substantial reductions in benefit costs because of the compounding effect. A $500 benefit in 1975 grew to $1,053 by 1984. It would have grown to only $1,006 if COLAs had been shaved by half a percentage point.

- For many beneficiaries, having benefits grow slightly more slowly than measured inflation would not pose serious problems. However, others, particularly very old beneficiaries who have outlived their assets, could find *any* reduction in benefit growth to be a problem.

Option: Reduce Cost-of-Living Adjustments By Half A Percent

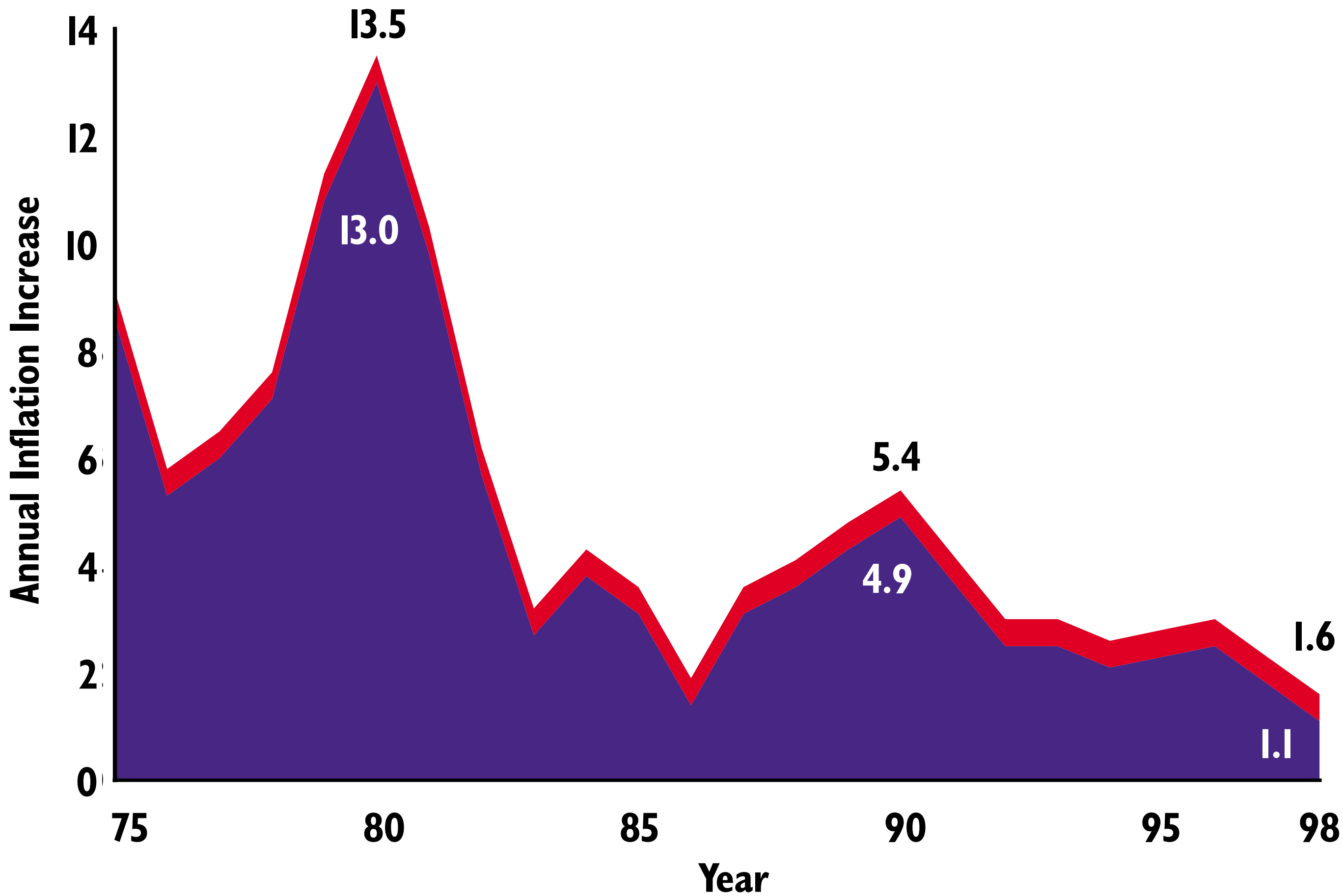

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CHART 60

It Takes Longer And Longer To Recover Social Security Taxes Plus Interest After Retirement

- When the Social Security program was young, beneficiaries had not paid payroll taxes for all their working years, and taxes were low. As a consequence, it took them relatively few months to get back in benefits their entire taxes plus interest. For people retiring as recently as 1980, benefits equaled total taxes in just a couple of years.

- However, for people retiring in 1997, it will take substantially longer to recover taxes plus interest.

- Eventually, average and maximum earners will have little chance of living long enough to ever get back what they paid into it.

- Any changes in the program to either raise taxes or reduce benefits will worsen the rate of return still further. Given the demographic changes ahead, this will be inevitable under the current program structure.

It Takes Longer And Longer To Recover Social Security Taxes Plus Interest After Retirement

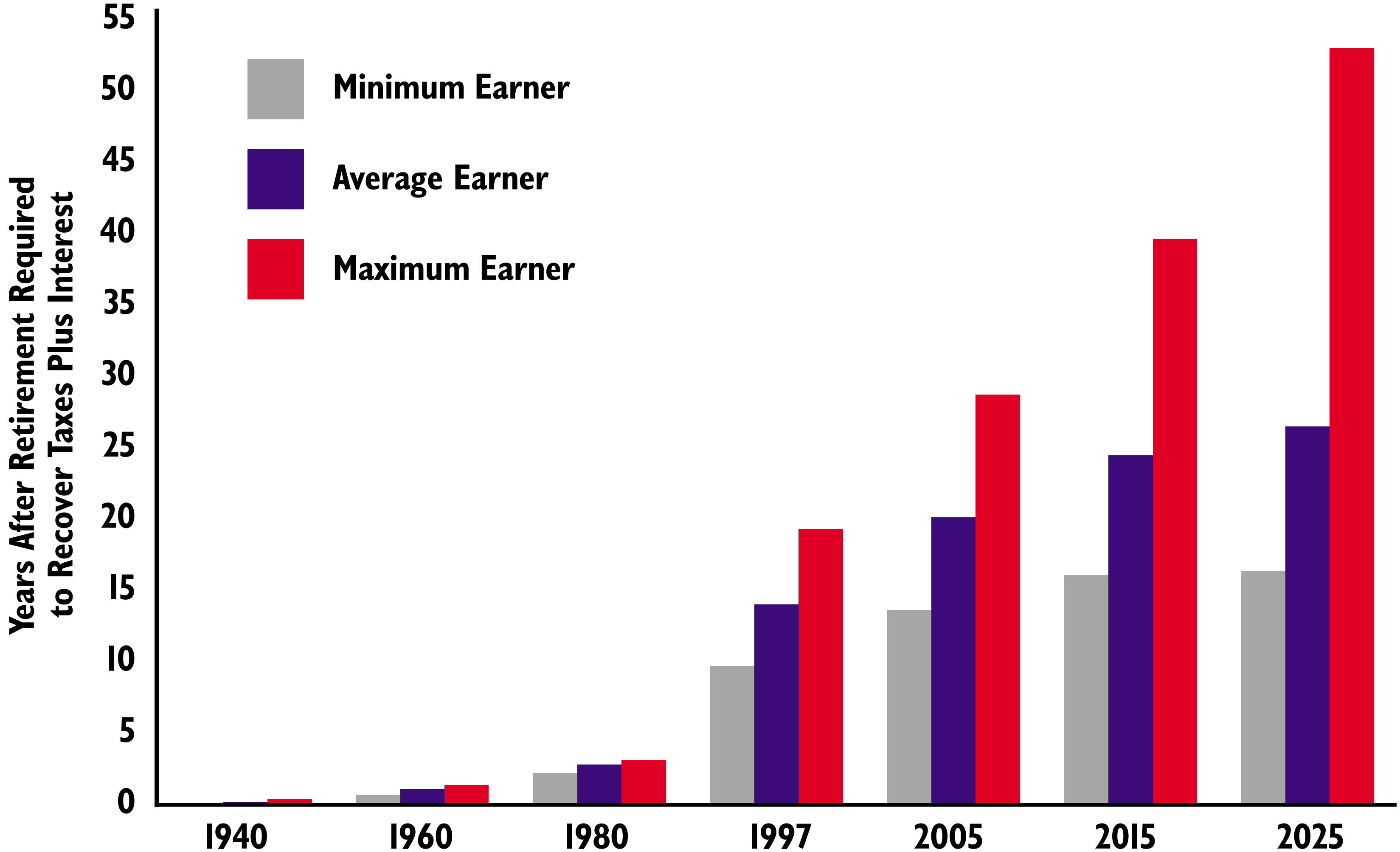

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CHART 6I: Option

Improve Investment Return

- Because of the political difficulty of either raising revenues or reducing benefits, many policy makers are looking "outside the box" for private market alternatives that would improve the return on investments.

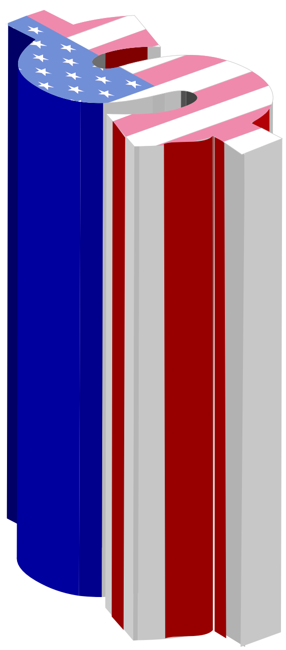
- **One option, proposed by President Clinton, would the for the Trust Fund to invest a portion of its assets in market securities** which historically have had a higher rate of return than Treasury bonds. Under this collective investment approach, the risk of market downturn would be borne by the government.

- **Another option would be to set up individually owned investment accounts.** These accounts could be designed to add a small supplement to Social Security or replace it entirely. Under this approach, the individual bears the risk and suffers the consequences of market downturn but enjoys the benefits if market rates continue to exceed Treasury bonds.

Improve Investment Return

Option:

Social Security Trust Fund Surplus Invested in Mix of Stocks and Bonds



Option:

Individually Owned Investment Account Established for Each Worker

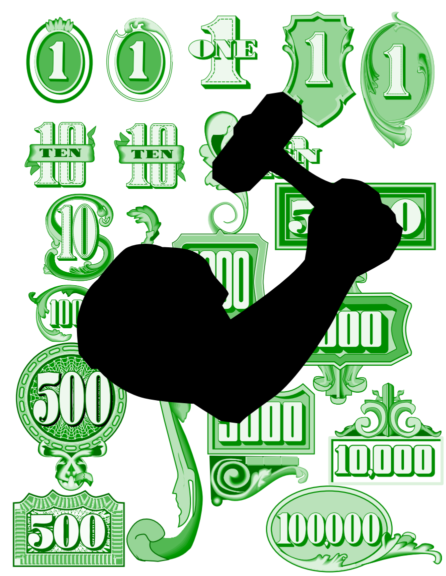


CHART 62: Option

Establish Individual Account Financing Options

- **Carve-Out:** The more that funds are diverted from the existing payroll tax to fund individual accounts, the deeper the benefit reductions will have to be to make the traditional program solvent.

  However, retirees will also get benefits from their individual accounts, which could more than make up for reductions in the traditional program.

  The traditional program would serve as a safety net for those whose investments did not provide adequate retirement income.

- **Add-On:** If additional payroll contributions are witheld to fund individual accounts, traditional benefits do not need to be cut more than the already deep cuts that will be required to make the program sustainable.

- **Somewhere Else:** Looking outside the payroll tax is also an option if budget surpluses materialize.

  This cannot be a permanent answer, however, because surpluses are expected to last, at best, for only 10 to 15 years.

  Since surpluses will not be permanent, care should be taken not to create a new entitlement that cannot be funded over the long-term.

  However, surpluses offer an opportunity for establishing individual accounts, setting up the administrative framework to handle them, and letting working-age citizens become familiar with how they operate.

By dedicating surpluses to retirement savings accounts, pressure would increase on politicians to make sure surpluses were not frittered away.

Options: Establish Individual Account Financing Options

Carve Out

Individual Accounts 2.0%

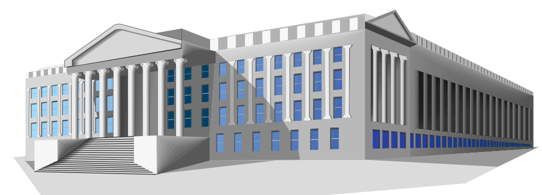
Traditional Program 10.4%

Add-On

Individual Accounts 2.0%

Traditional Program 12.4%

Somewhere Else



The Concord Coalition