

# CRS Issue Brief for Congress

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## **Social Security Reform**

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## Social Security Reform

### SUMMARY

Although the Social Security system is now running surpluses of income over outgo, its board of trustees projects that its trust funds would be depleted in 2042 and only 73% of its benefits would be payable then with incoming receipts. The trustees project that on average the system's cost would be 14% higher than its income over the next 75 years; by 2080 it would be 45% higher. The primary reason is demographic: the post-World War II baby boomers will begin retiring in less than a decade and life expectancy is rising. Between 2000 and 2025 the number of people age 65 and older is predicted to grow by 76%. In contrast, the number of workers supporting the system would grow by 17%.

The trustees project that Social Security's surplus of taxes and interest will cause the system's trust funds, comprised exclusively of federal bonds, to grow to a peak of \$6.6 trillion in 2027. The system's outgo thereafter would exceed its income and the trust funds would be drawn down until their depletion. However, the trustees project that the system's taxes by themselves would fall below its outgo beginning in 2018. At that point, other federal receipts would be needed to help pay for benefits (by providing cash as the federal bonds held by the trust funds are redeemed). If there are no other surplus governmental receipts, policymakers would have three choices: raise taxes or other income, cut spending, or borrow the money.

This adverse outlook is reflected in public opinion polls showing that fewer than 50% of respondents are confident that Social Security can meet its long-term commitments. There also is a growing perception that Social

Security may not be as good a value in the future. These concerns and a belief that the nation must increase its national savings have led to proposals to revamp the system.

Others suggest that the system's problems are not as serious as critics claim. They maintain that the system is now running surpluses, that the public still likes it, and that there is risk in some of the new reform ideas. They contend that only modest changes to the system are needed.

Today, the ideas range from restoring solvency with minimal changes to scrapping the system entirely for something modeled after IRAs or 401(k)s. This broad spectrum was reflected clearly in the report of a 1997 Social Security Advisory Council. The Advisory Council presented three very different plans, none of which received a majority of the council's endorsement. Similar diversity is reflected in the many reform bills introduced in recent Congresses. In his last three years in office, President Clinton also highlighted the issue. President Clinton proposed using the Social Security portion of then-projected budget surpluses to buy down the federal debt and crediting the system with the reductions — what effectively would be general fund infusions to the system.

In 2001, a commission appointed by President Bush recommended three sets of reform options, all of which feature personal accounts. In his 2005 State of the Union address, President Bush highlighted Social Security reform as a priority and outlined his guidelines for program changes, including the creation of personal accounts.

## **MOST RECENT DEVELOPMENTS**

In May 2001, President Bush appointed a commission to make recommendations to reform Social Security. The commission issued a report in December 2001 that presented three options to reform the program. All three feature individual accounts. In the 108<sup>th</sup> Congress, Representatives Shaw, Nick Smith, DeMint, Kolbe, Ryan, and Sam Johnson and Senators Lindsey Graham and Sununu introduced reform proposals that would have established personal accounts to supplement or replace part of the Social Security system (H.R. 75, H.R. 3055, H.R. 3177, H.R. 3821, H.R. 4851, H.R. 4895, S. 1878 and S. 2782, respectively). In addition, Representative Obey introduced a reform measure (H.R. 5179) that did not include the creation of personal accounts. Senator Corzine introduced a resolution (S.Res. 432) expressing the sense of the Senate that Congress should reject Social Security “privatization” proposals. In the 109<sup>th</sup> Congress, reform measures have been re-introduced by Representative Kolbe (H.R. 440) and Representative Johnson (H.R. 530). In his 2005 State of the Union address, President Bush highlighted Social Security reform as a priority and outlined his guidelines for an overall reform plan that includes the creation of personal accounts.

## **BACKGROUND AND ANALYSIS**

Although Social Security’s income is currently exceeding outgo, its board of trustees (three officers of the President’s Cabinet, the Commissioner of Social Security, and two members representing the public) projects that on average over the next 75 years Social Security’s outgo will exceed income by 14% and by 2042 its trust funds would be depleted. At that point, revenues would pay for only 73% of program costs. The primary reason is demographic: the post-World War II baby boom generation will be retiring soon and increasing life expectancy is creating an older society. Between 2000 and 2025, the number of people age 65 and older is predicted to rise by 76%, while the number of workers whose taxes will finance future benefits is projected to grow by only 17%. As a result, the number of workers supporting each recipient is projected to fall from 3.3 today to 2.3 in 2025.

Social Security revenues are paid into the U.S. Treasury and most of the proceeds are used to pay for benefits. Surplus revenue is invested in federal securities recorded to the Old Age, Survivors, and Disability Insurance (OASDI, the formal name for Social Security) trust funds maintained by the Treasury Department. Social Security benefits and administrative costs are paid out of the Treasury and a corresponding amount of trust fund securities are redeemed. Whenever current Social Security taxes are insufficient to pay benefits, the trust fund’s securities are redeemed and Treasury makes up the difference with other receipts.

Currently, Social Security tax revenues exceed what is needed to pay benefits. These surpluses and the interest the government “pays” to the trust funds appear as growing trust fund balances. The trustees project that the balances will grow to \$6.6 trillion in 2027, after which the system’s outgo would exceed its income and the balances would fall. By 2042, the trust funds would be exhausted and technically insolvent. The point at which Social Security taxes alone (ignoring interest paid to the funds) would fall below the system’s outgo is 2018. Since interest paid to the funds is an exchange of credits between Treasury accounts and not a resource for the government, in 2018 other federal receipts would be needed to help

meet the system's costs. At that point, policymakers would have three choices: raise taxes, cut spending, or borrow the needed money. The annual draw from the general fund (in 2004 dollars) is projected to be \$56 billion by 2020, and \$256 billion by 2030.

Today, the annual cost of the system (\$500 billion) is equal to 11.07% of workers' pay subject to Social Security taxation (or taxable payroll). It is projected to rise slowly over the next decade, reaching 11.76% of payroll in 2013. It would then rise more precipitously to 15.56% in 2025 and 17.56% in 2035, as the baby boomers retire. Afterward, the system's cost would rise slowly to 19.39% of payroll in 2080. The system's average cost over the entire period (2004-2078) would be 15.73% of payroll, or 14% higher than its average income. However, the gap between income and outgo would grow throughout the period and by 2080, income would equal 13.39% of payroll, outgo would equal 19.39% of payroll, and the gap would equal 6% of payroll. By 2080, outgo would exceed income by 45%.

This adverse outlook is mirrored in public opinion polls that show that fewer than 50% of respondents express confidence that Social Security can meet its long-term commitments. This skepticism is reinforced by a growing perception that Social Security may not be as good a value in the future. Until recent years, retirees could expect to receive more in benefits than they paid in Social Security taxes. However, because Social Security tax rates have increased to cover the costs of a maturing "pay-as you-go" system, these ratios have become less favorable. Such concerns and a belief that the nation must increase national savings to meet the needs of an increasingly elderly society have led to reform proposals.

Others suggest that the issues confronting the system are not as serious as sometimes portrayed. They point out that there is no imminent crisis, that the system is now running surpluses and is projected to do so for two decades or more, that the public still likes the program, and that there is considerable risk in some of the new reform ideas. They contend that modest changes could resolve the long-range funding problem.

## The Basic Debate

The current problem is not unprecedented. In 1977 and 1983, Congress enacted a variety of measures to address similar financial problems. Among them were constraints on the growth of *initial* benefit levels, a gradual increase from 65 to 67 in Social Security's *full retirement age* (i.e., the age for receipt of full benefits), payroll tax increases, taxation of Social Security benefits of higher-income recipients, and extension of coverage to federal and nonprofit workers. Subsequently, new long-term deficits have been forecast, resulting from changes in actuarial methods and assumptions, and from the passage of time (during which years of deficits at the end of the 75-year valuation period replace recent years of surpluses).

Many believe that action should be taken soon. This has been the view of the Social Security trustees and other recent panels and commissions that have examined the problem, and was echoed by a wide range of interest groups testifying in hearings during the past two Congresses. One of the difficulties is that there is no sense of "near-term" crisis. In 1977 and 1983, the trust funds' balances were projected to fall to zero in a very short time (within months of the 1983 rescue). Today, the problem is perceived to be as few as 14 or as many as 38 years away. Lacking a "crisis," the pressure to compromise is diffused and the issues and the divergent views about them have led to myriad complex proposals. In 1977 and

1983, the debate was not about fundamental reform; it revolved around how to raise the system's income and constrain its costs. Today, the ideas range from restoring the system's solvency with as few alterations as possible to replacing it entirely with something modeled after IRAs or 401(k)s. This broad spectrum was clearly reflected in the Social Security Advisory Council's report in 1997, which presented three different reform plans, none of which garnered a majority of the council's 13 members. Similar diversity is reflected in the many Social Security reform bills introduced in the past two Congresses.

**The Push for Major Reform.** Many advocates of reform see Social Security as an anachronism, built on depression-era concerns about high unemployment and widespread "dependency" among the aged. They see the prospect of reform today as an opportunity to modernize the way society saves for retirement. They maintain that the vast economic, social, and demographic changes that have transpired over the past 68 years require the system to change and point to changes made in other countries that now use market-based personal accounts to strengthen retirement incomes and bolster their economies by spurring savings and investments. They believe government-run, pay-as-you-go systems are unsustainable in aging societies. They prefer a system that lets workers acquire wealth and provide for their retirement by investing in personal accounts.

They also see it as a way to counter skepticism about the current system by giving workers a greater sense of ownership of their retirement savings. They contend that private investments would yield larger retirement incomes because stocks and bonds have provided higher returns than are projected from the current system. Some believe that personal accounts would correct what they see as Social Security's contradictory mix of insurance and social welfare goals, that is, its benefits are not based strictly on a person's contributions, yet because it is not means-tested, many of its social benefits go to well-to-do recipients. Others maintain that creating a system of personal accounts would prevent the government from using surplus Social Security taxes to "mask" government borrowing or other spending.

Others, not necessarily seeking a new system, see enactment of long-range Social Security constraints as one element of curbing federal entitlement spending. The aging of society means that the costs of the entitlement programs that aid the elderly will increase greatly in the future. The costs of the largest entitlement programs, Social Security, Medicare, and Medicaid, are directly linked to an aging population. Proponents of imposing constraints on these programs express concern that, if left unchecked, their costs would place a large strain on the federal treasury far into the future, consuming resources that could be used for other priorities and forcing future generations to bear a much higher tax burden.

Some contend that action is needed now as a matter of *fairness*. They point out that many of today's recipients get back more than they paid in Social Security taxes and far more than the baby boom generation will receive. They believe that to put off making changes is unfair to today's workers, who not only must pay for "transfer" payments that they characterize as "overgenerous" and unrelated to actual need, but also have the prospect that their own benefits will have to be scaled back severely. Others emphasize the trustees' adverse outlook and contend that steps need to be taken today (raising Social Security's full-benefit retirement age, constraining its future benefit growth, cutting COLAs, raising taxes, etc.) so that whatever is done to bring the system into balance can be phased in, giving workers time to adjust retirement expectations to reflect what these programs will be able to provide. Waiting, they fear, would require abrupt changes in taxes and benefits.

**The Arguments for Retaining the Existing System.** Those who favor a more restrained approach believe that its problems are resolvable with modest tax and spending changes and that the program's critics are raising the specter that Social Security will "bankrupt the Nation" in order to undermine public support and to provide an excuse to privatize it. They contend that personal savings accounts would erode the social insurance nature of the current system that favors low-income workers, survivors, and the disabled.

Others are concerned that switching to a new system of personal accounts would pose large transitional problems by requiring today's younger workers to save for their own retirement while paying taxes to cover current retirees' benefits. Some doubt that it would increase national savings, arguing that higher government debt (from the diversion of current payroll taxes to new personal accounts) would offset the increased personal account savings. They also contend that the capital markets' inflow created by the accounts would make the markets difficult to regulate and potentially distort equity valuations. They point out that some of the other countries that have moved to personal accounts did so to create capital markets. Such markets, they argue, are already well developed in the United States.

Some believe that a system of personal accounts would expose participants to excessive market risk for an income source that has become so essential to many of the nation's elderly. They say that the nation now has a three-tiered retirement system — consisting of Social Security, private pensions, and personal assets — that already has private saving and investment components. They contend that while people may want and be able to undertake some "risk" in the latter two tiers, Social Security — as the tier that provides a basic floor of protection — should be more stable. They further contend that the administrative costs of maintaining personal accounts could be very large and significantly erode their value.

Some say that concerns about growing entitlements are overblown, arguing that as people live longer, they will work longer as labor markets tighten and employers offer inducements for them to remain on the job. Moreover, a more liberal immigration policy could be used as a way to increase the labor force, if desired. They state that the projected low ratio of workers to dependents is not unprecedented; it existed when the baby boomers were in their youth. They point out that the baby boomers are now in their prime working and saving years and contend that the nation's savings rate will rise as the boomers age.

**The Basic Choices.** There are many options. The three alternatives offered by the 1994-1996 Social Security Advisory Council show that the range of choices is wide: maintaining the current system as much as possible; reducing its future commitments while mandating that workers save more on their own; and totally restructuring Social Security to incorporate a large personal account component. Although there is a consensus that action needs to be taken soon, there is uncertainty about what should be done and how quickly a consensus plan can be forged.

## Specific Areas of Contention

**The System's Financial Outlook.** There are conflicting views about the severity of Social Security's looming financial shortfall. Some maintain that the problem is more acute than has been portrayed traditionally (e.g., as having an average 75-year deficit of 14%, or 1.89% of taxable payroll). They believe their view has been buttressed by a new portrayal

in the most recent Trustees report that shows that, if projections are made beyond the 75-year window, the status of the program is even more dire (e.g., instead of 1.89% of taxable payroll over the next 75 years, the long-range deficit looking indefinitely into the future would be 3.5% of taxable payroll). They also point out that the system's costs are projected to exceed receipts by 3.62% of taxable payroll in 2030 (i.e., there would be a difference of 27% between the system's projected income — 13.21% of taxable payroll — and the system's projected cost — 16.83% of taxable payroll). In 2080, the gap would be 6% of taxable payroll (i.e., there would be a difference of 45% between the system's projected income — 13.39% of taxable payroll — and the system's projected cost — 19.39% of taxable payroll). Thus, on a pay-as-you-go basis, the system would need a lot more than a 14% change in taxes or expenditures over the next 75 years to be able to meet its promises. They maintain that thinking the problem is 37 years away (because the trust funds would not be depleted until 2042) ignores the financial pressure Social Security will exert on the government when projected expenditures exceed taxes in 2018 (and beyond). At that point, the government would have to use other resources to help pay the benefits, resources that would otherwise be used to finance other governmental functions.

Others express concern that the problem is being exaggerated. First, they maintain that in contrast to earlier episodes of financial distress, the system has no immediate problem. Surplus tax receipts are projected for 13 years and the trust funds are projected to have a balance for 37 years. They state that projections for the next 75 years, let alone the indefinite future, cannot be viewed with any significant degree of confidence and Congress should respond to them cautiously. They maintain that even if the 75-year projections hold, the average imbalance could be eliminated by simply increasing the payroll tax rate immediately by 0.95 percentage points on both employees and employers. They point out that as a share of GDP, the projections show the system's cost rising from only 4.33% today to 6.31% in 2030. While acknowledging that this would be a notably larger share of GDP, they point out that GDP itself would have risen substantially in real terms. Moreover, while the ratio of workers to recipients is projected to decline, they believe that employers are likely to respond with inducements for older workers to stay on the job longer. Phased-in retirements already are becoming more prevalent, and older workers are increasingly seeing retirement as something other than an all-or-nothing decision.

The preceding discussion of the system's long-range financial outlook reflects the intermediate projections of the Social Security Board of Trustees. Projections released by the Congressional Budget Office (CBO) provide a somewhat more favorable long-range outlook for the Social Security system. In its 2004 report, *The Outlook for Social Security*, CBO projected that the Social Security system will begin running cash flow deficits in 2019 (1 year later than projected by the trustees) and that the trust funds will be depleted in 2052 (10 years later than projected by the trustees). At that point, an estimated 80% of promised benefits would be payable. Overall, CBO projected that the system's average 75-year actuarial deficit will be equal to 1.00% of taxable payroll, compared to 1.89% under the trustees' latest projections (a difference of 47%). In terms of Social Security's size relative to the economy, CBO projected that, by 2080, outlays will be equal to 6.7% of GDP (compared to 6.6% projected by the trustees) and revenues will be equal to 4.9% of GDP (compared to 4.6% projected by the trustees). CBO attributed the differences between its projections and the trustees' projections to the use of different economic assumptions and methodology. Despite the differences, however, CBO noted that the basic conclusion is the same — “under current law, the program will generate a sustained and significant demand

for budgetary resources” [page 29]. The CBO report may be accessed at [<http://www.cbo.gov/showdoc.cfm?index=5530&sequence=0&from=7>]. In January 2005, CBO updated their estimate of the year in which the system will begin running cash flow deficits from 2019 to 2020.

**Public Confidence.** Polls in recent years have shown that a majority of Americans have a low level of confidence in the Social Security program. Although skepticism abated following legislation in 1983 that shored up the system, it has risen again with just over half of the public now expressing a lack of confidence [CBS News/New York Times Poll, November 2004]. Younger workers are particularly skeptical. Fifty-seven percent of those ages 18-29 and 67% of those ages 30-49 expressed little confidence in the system compared to 35% of those ages 50-64 [Newsweek Poll, June 2000].

Some observers caution about inferring too much from polling data, arguing that public understanding of Social Security is limited and often inaccurate. They maintain that a major reason confidence is highest among older persons is that, being more immediately affected, they have learned more about the program. Younger workers receive little information about Social Security unless they request it, which very few do. In 1995, the Social Security Administration began phasing in a system to provide annual statements to workers, which some believe will make workers more aware of their promised benefits and thus more trusting of the system. Others, however, suggest the skepticism is justified by the system’s repeated financial difficulties and its diminished “money’s worth” to younger workers.

**Doubts About Money’s Worth.** Until recent years, Social Security recipients received more, often far more, than the value of the Social Security taxes they paid. However, because Social Security tax rates have increased over the years and the age for full benefits is scheduled to rise, it is becoming increasingly apparent that Social Security will be less of a good deal for many future recipients. For example, for workers who earned average wages and retired in 1980 at age 65, it took 2.8 years to recover the value of the retirement portion of the combined employee and employer shares of their Social Security taxes plus interest. For their counterparts who retired at age 65 in 2003, it will take 17.4 years. For those retiring in 2020, it will take 21.6 years (based on the trustees’ 2003 intermediate forecast). Some observers believe these discrepancies are inequitable and cite them as evidence that the system needs to be substantially restructured.

Others discount this phenomenon, viewing Social Security as a *social insurance* program serving social ends that transcend questions of whether some individuals do better than others. For example, the program’s anti-poverty features replace a higher proportion of earnings for low-paid workers and provide additional benefits for workers with families. Also, today’s workers who will receive less direct value from their taxes than today’s retirees, have in large part been relieved from having to support their parents, and many elderly are able to live independently and with dignity. These observers contend that the value of these aspects of the system is not reflected in simple comparisons of taxes and benefits.

**“Privatization” Debate.** Social Security’s financing problems, skepticism about its survival, and a belief that economic growth could be bolstered through increased savings have led to a number of proposals to “privatize” part or all of the system, reviving a philosophical debate that dates back to its creation in 1935. All three alternative plans of the

1996 Advisory Council featured program involvement in the financial markets. The first called upon Congress to consider authorizing investment of part of the Social Security trust funds in equities (on the assumption that stocks would produce a higher return to the system). The second would require workers to contribute an extra 1.6% of their pay to new personal accounts to make up for Social Security benefit cuts it called for to restore the system's long-range solvency. The third would redesign the system by gradually replacing Social Security retirement benefits with flat-rate benefits based on length of service and personal accounts (funded with 5 percentage points of the current Social Security tax rate).

The reform that Chile enacted in 1981, which replaced a troubled pay-as-you-go system with one requiring workers to invest part of their earnings in personal accounts through government-approved pension funds, has been reflected in a number of reform bills introduced in recent Congresses. They would permit or require that workers invest some or all of their Social Security tax into personal accounts. Most call for future Social Security benefits to be reduced or forfeited. Likewise, the three options presented by President Bush's commission would allow workers to choose to participate in personal accounts and would reduce their eventual Social Security benefit by the projected value of the account based on a specified (rather than the actual) rate of return.

Still another approach is reflected in bills that would require that future budget surpluses be used to finance personal accounts to supplement Social Security benefits for those who pay Social Security taxes. President Clinton's January 1999 reform plan would have allocated a portion of the surpluses to personal accounts supplemented by a worker's own contributions and a government match (scaled to income). Another part of his plan called for the diversion of a portion of budget surpluses or the interest savings resulting therefrom to the Social Security trust funds, some of which would be used to acquire stocks, similar to the approach suggested in the one of the Advisory Council's plans and in some recent bills. Most of these approaches require that a new independent board would invest some of these new funds in stock or corporate bonds and the rest in federal securities.

Many personal account proponents believe that they would reduce future financial demands on government and reassure workers by giving them a sense of ownership of their retirement savings. Others believe that they would enhance workers' retirement income because stocks and bonds generally have provided higher rates of return than are projected from Social Security. In concert with this, they maintain that personal accounts would increase national savings and promote economic growth. Some believe personal accounts would correct what they view as Social Security's contradictory mix of insurance and social welfare goals — that benefits are not based strictly on the level of a person's contributions, yet many of its social benefits go to well-to-do recipients. Others maintain that personal accounts would prevent the government from using surplus Social Security revenues to "mask" public borrowing or for other spending or tax cuts. Generally, proponents of personal accounts express concern that investing the Social Security trust funds in the markets would concentrate too much economic power in a government-appointed board.

Opponents of personal accounts maintain that Social Security's problems can be solved without altering the program's fundamental nature. They express concern that replacing Social Security with personal accounts would erode the social insurance aspects of the system that favor low-wage earners, survivors and the disabled. Others are concerned that personal accounts would pose large transition problems by requiring today's younger workers

to save for their own retirement while simultaneously paying taxes to support current retirees, and would further exacerbate current budget deficits. Some doubt that they would increase national savings, maintaining that any increase in private savings would be offset by more borrowing by the government. They also point out that the investment pool created by the accounts could be difficult to regulate and distort capital markets and equity valuations. Still others view it as exposing participants to excessive market risk for something as essential as core retirement benefits and, unlike Social Security, as providing poor protection against inflation. Many prefer “collective” investment of the Social Security trust funds in the markets to potentially bolster their returns and spread the risks of poor performance broadly.

**The Retirement Age Issue.** Raising the Social Security retirement age is often considered as a way to help restore the system’s solvency. Much of the growth in Social Security’s costs is a result of rising life expectancy. From 1940, when benefits were first paid, the life expectancy for 65-year-old men and women has risen from 12.7 and 14.7 years to 16.7 and 19.5 years, respectively, and by 2030 it is projected to be 18.4 and 21.2 years, respectively. This trend bolstered arguments for increasing Social Security’s full benefit age as a way to achieve savings when the system was facing major financial problems in the early 1980s. Congress boosted the “full benefit” age from 65 to 67 as part of the Social Security Amendments of 1983 (P.L. 98-21). This change is being phased in starting with those born in 1938, with the full two-year hike affecting those born after 1959. It will not raise the first age of eligibility, now age 62, but the benefit reduction for retiring at 62 will rise from 20% to 30%. Proponents of raising one or both of these ages further see it as reasonable in light of past and projected increased longevity. Opponents say it will penalize workers who already get a worse deal from Social Security than do current retirees, those who work in arduous occupations, and racial minorities and others who have shorter life expectancies.

**Cost-of-Living Adjustments (COLAs).** Social Security benefits are adjusted annually to reflect inflation. Social Security accounts for 80% of the federal spending on COLAs. These COLAs are based upon the Bureau of Labor Statistics’ (BLS) Consumer Price Index (CPI), which measures price increases for selected goods and services. The CPI has been criticized for overstating the effects of inflation, primarily because the index’s market basket of goods and services was not revised regularly to reflect changes in consumer buying habits or improvements in quality. A BLS analysis in 1993 found that the annual overstatement might be as much as 0.6 percentage points. CBO estimated in 1994 that the overstatement ranged from 0.2 to 0.8 percentage points. A 1996 panel that studied the issue for the Senate Finance Committee argued that it might be 1.1 percentage points.

In response to its own analysis as well as the outside criticisms, the BLS has since made various revisions to the CPI. To some extent, these revisions may account for part of the slower CPI growth seen in recent years. However, calls for adjustments continue. According to SSA’s actuaries, a COLA reduction of 1 percentage point annually would eliminate almost four-fifths of Social Security’s long-range deficit (based on the trustees’ 2003 intermediate forecast). While some view further CPI changes as necessary to help keep Social Security and other entitlement expenditures under control, others view such changes as just a backdoor way of cutting benefits. They maintain that the market basket of goods and services purchased by the elderly is different from that of the general population around whom the CPI is constructed. It is more heavily weighted with healthcare expenditures, which rise notably faster than the overall CPI, and thus they contend that the cost of living for the elderly is higher than reflected by the CPI.

**Social Security and the Budget.** By law, Social Security is considered to be “off budget” for many aspects of developing and enforcing annual budget goals. However, it is still a federal program and its income and outgo help to shape the year-to-year financial condition of the government. As a result, policymakers often focus on “unified” or overall budget figures that include Social Security. When President Clinton urged that future unified budget surpluses be reserved until Social Security’s problems were resolved, and proposed using a portion of the surpluses to shore up the system, Social Security’s budget treatment became a major issue. Congressional views about what to do with the surpluses were diverse, ranging from “buying down” publicly-held federal debt to cutting taxes to increasing spending. However, support for setting aside a portion equal to the annual Social Security trust fund surpluses was substantial. The 106<sup>th</sup> Congress passed budget resolutions for FY2000 and FY2001 that incorporated budget totals setting Social Security surpluses aside pending consideration of reform legislation. It went on to consider, but did not pass, additional “lock box” measures intended to create procedural obstacles for bills that would divert these set asides for tax cuts or spending increases. Similar legislation in the 107<sup>th</sup> Congress, H.R. 2, was passed by the House in February 2001.

In 1998, the House Republican leadership attempted to define the use of budget surpluses with passage of H.R. 4579, which would have created a new Treasury account to which 90% of the next 11 years’ projected surpluses would have been credited. The underlying principle was that 10% of the budget surpluses would be used for tax cuts and the remainder held in abeyance until Social Security reforms were enacted. However, the bill was heavily opposed by Democratic Members who argued for holding 100% of the surpluses in abeyance, and the Senate did not take up the measure before the 105<sup>th</sup> Congress adjourned.

## Reform Initiatives

Although the 1994-96 Social Security Advisory Council could not reach a consensus on a single plan, its 1997 report contained three different approaches to restore the system’s solvency. The first (the “maintain benefits” plan) would keep the system’s benefit structure essentially intact by increasing revenue (including an eventual rise in the payroll tax) and making minor benefit cuts. Its proponents also suggested that part of the Social Security trust funds be invested in stocks. The second (the “individual account” plan) addressed the problem mostly with benefit reductions, and in addition would require workers to make an extra 1.6% of pay contribution to new personal accounts. The third (the “personal security account” plan) proposed a major redesign of the system that would gradually replace the current earnings-related retirement benefit with a flat-rate benefit based on length of service and establish personal accounts funded by diverting to them 5 percentage points of the current payroll tax. It would cover *transition* costs with an increase in payroll taxes of 1.52% of pay and government borrowing. The conceptual approaches reflected in the Council’s plans can be found in many reform bills introduced in recent Congresses.

In his last three years in office, President Clinton repeatedly called for using Social Security’s share of looming budget surpluses to reduce publicly-held federal debt and crediting the trust funds for the reduction. In his 1999 State of the Union message, he proposed crediting \$2.8 trillion of some \$4.9 trillion in budget surpluses projected for the next 15 years to the trust funds — nearly \$.6 trillion was to be invested in stocks, the rest in federal securities. The plan was estimated to keep the system solvent until 2059. Critics

raised concerns that it was crediting Social Security's trust funds twice for its surpluses and that the plan would lead to Government ownership of private companies, which they maintained ran counter to the nation's free enterprise system. Clinton further proposed that \$.5 trillion of the budget surpluses be used to create new Universal Savings Accounts (USAs) — 401(k)-like accounts intended to supplement Social Security. In June 1999, he revised his plan by calling for general fund infusions to the trust funds equal to the interest savings achieved by using Social Security's share of the budget surpluses to reduce federal debt. The infusions were to be invested in stocks until the stock portion of the trust funds' holdings reached 15%. In October 1999, he revised the plan again by dropping the stock investment idea — all the infusions were to be invested in federal bonds. His last plan, offered in January 2000, was similar but again called for investing up to 15% of the trust funds in stock.

In May 2001, President Bush appointed a commission to make recommendations to reform Social Security. As principles for reform, the President stated that it must preserve the benefits of current retirees and older workers, return Social Security to a firm financial footing, and allow younger workers to invest in personal savings accounts. The commission issued a final report on December 21, 2001, which included three reform options. Each option would allow workers to participate in voluntary personal accounts and reduce their eventual Social Security benefit by the projected value of the account based on a specified (rather than the actual) rate of return. The first option would allow workers to divert 2% of taxable earnings to these accounts, but would make no other changes. The second option would allow workers to divert 4% of taxable earnings, up to an annual maximum of \$1,000; reduce future benefits by indexing their growth to prices rather than wages; and increase benefits to low-paid workers and widow(er)s. The third option would allow workers to contribute an additional 1% of taxable earnings and receive a government match of 2.5% up to an annual maximum of \$1,000; reduce future benefits by indexing their growth to increases in longevity and, for high-paid workers, by modifying the benefit formula; and increase benefits for low-paid workers and widow(er)s.

On February 2, 2005, President Bush highlighted Social Security reform during his State of the Union address. The President did not present a detailed plan for reform. Rather, he used this opportunity to put forth guidelines for Congress to consider in the development of legislation to create personal accounts within a program in need of "wise and effective reform."

The President offered the following guidelines for reform: (1) workers born before 1950 (i.e., workers age 55 and older in 2005) would not be affected by personal accounts or other components of reform; (2) participation in personal accounts would be voluntary; (3) eligible workers would be allowed to divert up to 4% of covered earnings into a personal account, initially up to \$1,000 per year; (4) a centralized government entity would administer the accounts; (5) account assets would be available at retirement (i.e., assets would not be available in the event of disability); workers would be required to annuitize the portion of the account balance needed to provide at least a poverty-level stream of life-long income, with any remaining balance available as a lump sum.

While the President restated his support for personal accounts, he acknowledged that other changes would be needed to address the system's projected long-range funding problem. The President cited several potential program changes that would be on the table for consideration: (1) raising the full retirement age; (2) reducing benefits for wealthy

recipients; and (3) modifying the benefit formula. The only approach ruled out by the President was an increase in payroll taxes, however, he did not specify whether this was in reference to payroll tax rates, increases in the amount of earnings subject to the payroll tax, or both.

**Legislation in the 109<sup>th</sup> Congress.** In the 109<sup>th</sup> Congress, Representative Kolbe and Representative Johnson have re-introduced their reform bills from the 108<sup>th</sup> Congress (H.R. 440 and H.R. 530, respectively). The full text of these bills is not yet available on the Legislative Information System.

**Legislation in the 108<sup>th</sup> Congress.** Representative Shaw introduced H.R. 75 on January 7, 2003. The bill would have established voluntary personal accounts funded with general revenues and scaled annual contributions by limiting them to the *lesser* of 4% of taxable earnings and \$1,000 (indexed to average wage growth). The bill would have allowed workers to choose among three investment portfolios, each with different mixes of stocks and bonds. Upon benefit entitlement, an amount equal to 95% of a “life annuity” would have been transferred monthly from each worker’s account to the Social Security system, and the higher of a current-law Social Security benefit or the life annuity would have been paid to the recipient (in effect, the annuity would have funded some or all of the Social Security benefit). The remaining 5% of the account balance would have been paid to the worker as a lump sum. The bill would have eliminated the earnings test for all retirees, and enhanced spousal benefits by increasing benefits for divorced spouses, workers who stay home to care for children, and retired or disabled widow(er)s.

Representative Nick Smith introduced H.R. 3055 on September 10, 2003. The bill would have allowed workers to redirect part of their payroll taxes to personal accounts and reduced the worker’s Social Security benefit based on the value of the account, assuming it were invested at a specified interest rate. Workers would have been allowed to make additional contributions of up to \$2,000 annually. The bill would have reduced Social Security benefits for most recipients through benefit formula modifications and increases in the full and early retirement ages. It would have increased delayed retirement credits and benefits for widow(er)s, provided a minimum benefit and child care drop-out years, and covered newly-hired state and local government workers.

Representative DeMint introduced H.R. 3177 on September 25, 2003. The measure would have established voluntary personal accounts funded with Social Security payroll taxes equal to 3% to 8% of taxable earnings (depending on the worker’s earnings level). Specifically, workers would have been enrolled automatically in the personal account system and given the option to disenroll from the plan. Social Security benefits would have been offset by an amount equal to the account’s annuity value, assuming an investment mix of 65% stocks, 35% government bonds and annuitization of the total account balance. Workers, however, would have been allowed to take up to 65% of the account balance as a lump sum, if the remaining balance were to provide a combined monthly payment (net Social Security benefit plus annuity) at least equal to the poverty level. The bill would have guaranteed a monthly payment (based on annuitization of the total account balance) at least equal to current-law Social Security benefits. It would have provided general revenue transfers to the Social Security trust funds to maintain reserves equal to about one year’s worth of net Social Security expenditures.

Senator Lindsey Graham introduced S. 1878 on November 18, 2003. The bill would have allowed workers age 25 and older to choose one of three options for the Social Security program. Option 1 would have allowed workers under age 55 to redirect 4 percentage points of the payroll tax to personal accounts. Social Security benefits would have been reduced by the value of a hypothetical account annuity based on the worker's contributions compounded at an interest rate 0.3% below that of long-term government bonds, and by reductions in the Social Security benefit formula. Social Security benefits would have been increased for widow(er)s and low-paid workers. Option 2 would not have included personal accounts, but it would have included the reductions in the Social Security benefit formula and the increases for widow(er)s and low-paid workers under Option 1. Option 3, which would not have included personal accounts, would have maintained current-law benefits by increasing payroll taxes in the amount needed to fund them.

Representatives Kolbe and Stenholm introduced H.R. 3821 on February 24, 2004. For workers under age 55, the measure would have redirected 3% of the first \$10,000 of covered earnings (indexed to average wage growth) and 2% of remaining covered earnings to mandatory personal accounts. Workers would have been allowed to make additional contributions of up to \$5,000 annually (indexed to inflation), and lower-paid workers would have been eligible to receive an additional credit toward their account of up to \$600. The measure would have provided for benefit formula constraints to limit the future growth of benefits for middle and high-paid workers; reduced Social Security cost-of-living adjustments; increased widow(er)s' benefits to 75% of the couple's combined pre-death benefit; limited spousal benefits such that a couple's combined benefit would not have exceeded the maximum benefit payable to a hypothetical single worker with the same eligibility year as the retired worker; and provided a minimum benefit tied to the poverty level. The measure would have increased revenue by increasing the taxable wage base and crediting all of the revenue from the taxation of Social Security benefits to the Social Security trust funds (instead of crediting part to Medicare).

Representative Paul Ryan introduced H.R. 4851 on July 19, 2004. Senator Sununu introduced a companion measure (S. 2782) on September 9, 2004. The bill would have allowed workers under age 55 to redirect a portion of payroll taxes to voluntary personal accounts. Workers would have been allowed to redirect 10% of the first \$10,000 of covered earnings (indexed to average wages) and 5% of remaining covered earnings to personal accounts. SSA's Office of the Chief Actuary estimated that, on average, 6.4 percentage points of the 12.4% payroll tax would have been diverted to personal accounts. Workers who participated in personal accounts would have been issued a "benefit credit certificate" (or recognition bond) to reflect benefits accrued under the traditional system, although benefits would have been reduced to reflect the payroll taxes diverted to the worker's account. (Benefits for disabled workers and their dependents and benefits for survivors (except elderly widow(er)s) would not have been subject to the reduction.) The bill would have guaranteed account participants a combined payment (traditional benefit plus annuity) at least equal to current-law Social Security benefits. Workers who chose not to participate in personal accounts would have received traditional Social Security benefits.

The proposal would have provided three initial investment options with specified allocations in equities and fixed income instruments (e.g., U.S. government bonds, corporate bonds), including a default option of 65% equities, 35% fixed income instruments. Once the worker's account balance reached at least \$2,500 (indexed to inflation), additional

investment options would have been available. At retirement, the worker would have been required to annuitize the portion of the account balance needed to provide a combined payment (traditional benefit plus inflation-indexed annuity) at least equal to current-law Social Security benefits. Any excess balance would have been available for withdrawal in a manner chosen by the worker. Pre-retirement distribution would have been allowed if the account were sufficient to provide an annuity at least equal to a required minimum payment. The measure also contained several financing provisions, including one that would have reduced future growth rates for federal spending.

Representative Sam Johnson introduced H.R. 4895 on July 22, 2004. The bill would have allowed workers under age 55 to redirect 6.2 percentage points of the payroll tax to voluntary personal accounts. Workers who participated in personal accounts would no longer have accrued benefits under the traditional system and would have been issued a recognition bond to take into account benefits already accrued. Workers who chose not to participate in personal accounts would have remained in the traditional system, although initial Social Security benefits for future retirees would have been lower than benefits promised under current law. Under current law, initial benefits are indexed to average wage growth. The measure would have constrained the growth in initial benefits for future retirees by indexing initial benefits to price growth, rather than wage growth. This benefit formula change would not have applied to disability benefits.

The proposal would have provided at least three initial investment options, each with specified allocations in equities and fixed income instruments (e.g., U.S. government bonds, corporate bonds), including a default option of 60% equities, 40% fixed income instruments. Once the worker's account balance reached at least \$10,000 (indexed to inflation), additional investment options would have been available. Account assets would have been available at retirement, or earlier if the account balance would have provided an annuity at least equal to 120% of the poverty line. The worker would have had three distribution options: annuity, programmed withdrawal, or a combination of annuity and partial lump sum. Under the third option, the worker would have been allowed to take as a lump sum the portion of the account balance in excess of that needed to provide an annuity at least equal to 120% of the poverty line. If the worker's account balance was not sufficient to provide an annuity at least equal to 120% of the poverty line, a supplemental payment would have been made to the account from general revenues to provide the guaranteed minimum benefit payment.

Senator Corzine introduced S.Res. 432 on September 22, 2004, expressing the sense of the Senate that Congress should reject Social Security "privatization" proposals.

Representative Obey introduced H.R. 5179 on September 29, 2004. The bill would have increased the rate of growth in the Social Security taxable wage base by 2 percentage points above average wage growth for years 2006 through 2036, to bring the percent of covered earnings subject to the Social Security payroll tax up to 90%; used an alternative Consumer Price Index measure to compute cost-of-living adjustments for current and future retirees; retained the estate tax (with an applicable exclusion amount of \$3.5 million) and earmarked estate tax revenues for Social Security; and provided for future adjustments in the Social Security payroll tax rate (employer/employee shares), if needed to bring the system into balance based on the intermediate projections of the Social Security Board of Trustees.

During the 108<sup>th</sup> Congress, reform measures were not considered by the House of Representatives or the Senate. Congress approved H.R. 743 (*The Social Security Protection Act of 2004*), designed to provide additional safeguards for Social Security and Supplemental Security Income recipients with representative payees and enhance program protections. President Bush signed the measure into law on March 2, 2004 (P.L. 108-203). For more information, see CRS Report RL32089, *The Social Security Protection Act of 2004*.

## **LEGISLATION**

In the 109<sup>th</sup> Congress, Representative Kolbe and Representative Johnson introduced H.R. 440 and H.R. 530, respectively. This section will be updated as information becomes available in the Legislative Information System.