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Fixing Social Security:

Adequate Benefits, Adequate Financing

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The National Academy of Social Insurance (NASI) is a nonprofit, nonpartisan organization made up of the nation's leading experts on social insurance. Its mission is to promote understanding of how social insurance contributes to economic security and a vibrant economy. Social insurance encompasses broad-based systems for insuring workers and their families against economic insecurity caused by loss of income from work and the cost of health care. NASI's scope covers social insurance such as Social Security, Medicare, workers' compensation, and unemployment insurance, and related public assistance and private employee benefits.

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The purpose of this report is to help analysts, policymakers, journalists, constituent organizations, and interested citizens consider how to bring Social Security into long-range balance in ways that address concerns about benefit adequacy.

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The Office of the Chief Actuary of the Social Security Administration prepared the cost estimates in this report. Some estimates are preliminary and may change with more refined analysis.

Virginia Reno, Vice President for Income Security, and Joni Lavery, Senior Policy Associate at the National Academy of Social Insurance, prepared this report. Jill Braunstein, NASI's Director of Communications, oversaw layout and Elizabeth Lamme, Income Security Policy Assistant, oversaw production of the report.

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Introduction

The purpose of this report is to help analysts and policymakers consider options to bring Social Security into long-term balance in ways that also address concerns about benefit adequacy. According to the 2009 report of the Social Security Trustees, the program will continue to run annual surpluses until the end of 2023, at which time it will have an accumulated reserve of $4.3 trillion. Then, Social Security will gradually draw down its reserves. In the unlikely event that legislation is not enacted to address the projected shortfall, the Trustees project that all reserves will be drawn down before the end of 2037, at which point Social Security is projected to have sufficient resources to pay on time only about three-quarters of scheduled benefits. If these long-term projections hold true, it will be necessary for Congress to increase income to the system or reduce outgo at some time in the future in order to continue to pay full benefits on a timely basis after 2037. At the same time, Social Security's benefits are modest, both in absolute terms and in terms of the percentage of wages replaced. In light of the trillions of dollars of losses in savings and home equity experienced in the last year, the adequacy of Social Security benefits is a subject of growing concern. This report presents policy options to improve the adequacy of benefits and other options to bring the Social Security system into long-term balance. Before presenting the options, we consider why Social Security benefit adequacy is a concern and the state of Social Security finances.

WHY CARE ABOUT ADEQUACY?

Older Americans and disabled workers and their families rely heavily on Social Security today and are likely to continue to rely on it in the future as the financial crisis has weakened other sources of economic security. Benefits today are modest in relation to what it takes for retirees to make ends meet. Looking to the future, Social Security will do a less adequate job of replacing retirees' prior earnings if benefits are not increased.

Benefits are modest. The average retired-worker benefit in January 2009 was $1,155 per month, or about $13,860 per year (Social Security Administration (SSA) 2009). That is more than the official poverty guideline for an older person living alone ($10,830 in 2009), but that guideline (calculated as three times minimal food requirements) fails to explicitly take into account health care and housing, both rapidly rising expenses in the budgets of most

households. Consequently, the poverty guideline is considerably lower than what it takes to make ends meet according to more up-to-date measures of elders' living expenses (Wider Opportunities for Women 2009; Blank and Greenberg 2008). And, of course, many elders receive less than the average benefit. One who worked steadily at the federal minimum wage and claimed benefits at age 62 would receive a Social Security benefit that falls short of the poverty line by about 25 percent (SSA 2009a, Table 2.A26). New analyses of what it takes to make ends meet find that an older American in good health living alone in 2008 would need about $16,300 if she or he owned a home, mortgage free. A renter in good health would need more, about $20,250 a year, while a homeowner still paying a mortgage would need about $24,000 to make ends meet (Kuriansky and McMahon 2009). The average Social Security benefit would cover about two-thirds of the renter's basic costs and about 55 percent of basic costs for one with a mortgage.

Social Security "take-home" pay will not keep up with wage growth in the future. The adequacy of retirement income is often assessed in terms of "replacement rates" – that is, the fraction of a retiree's prior earnings that is replaced by retirement benefits. By international standards, Social Security replacement rates are low (Organisation for Economic Co-operation and Development 2009). Moreover, American retirees will get less adequate wage replacement from Social Security in the future. "Take-home pay" refers to Social Security benefits minus the cost of Medicare Part B premiums, which are deducted directly from the monthly Social Security payments to most beneficiaries.[1] Currently, take-home pay for a median earner retiring at age 65 replaces about 39 percent of prior lifetime earnings, but it will fall to 32 percent for a similar 65-year-old retiree in 2030. The decline is due to a legislated increase in the age for receiving unreduced Social Security benefits and the fact that Medicare premiums will grow faster than Social Security benefit levels (Munnell 2009; Reno and Lavery 2007).[2]

Social Security is critically important to beneficiaries. If seniors had to rely on only their income other than Social Security, nearly one in two seniors would be poor; with Social Security less than one senior in ten is poor (Sherman and Shapiro 2005). At the same time, Social Security is more than an anti-poverty program. The benefits are an important share of income for middle- and upper-middle-income elders as well as for low-income retirees. In Figure 1, elders are divided into five equal groups based on their total incomes. Each pie chart shows the share of the group's total income that comes from Social Security, pensions, earnings from work, asset income, and other sources. Elders in the bottom two fifths of the income distribution (with incomes below $18,600 in 2006) drew roughly 80 percent of their

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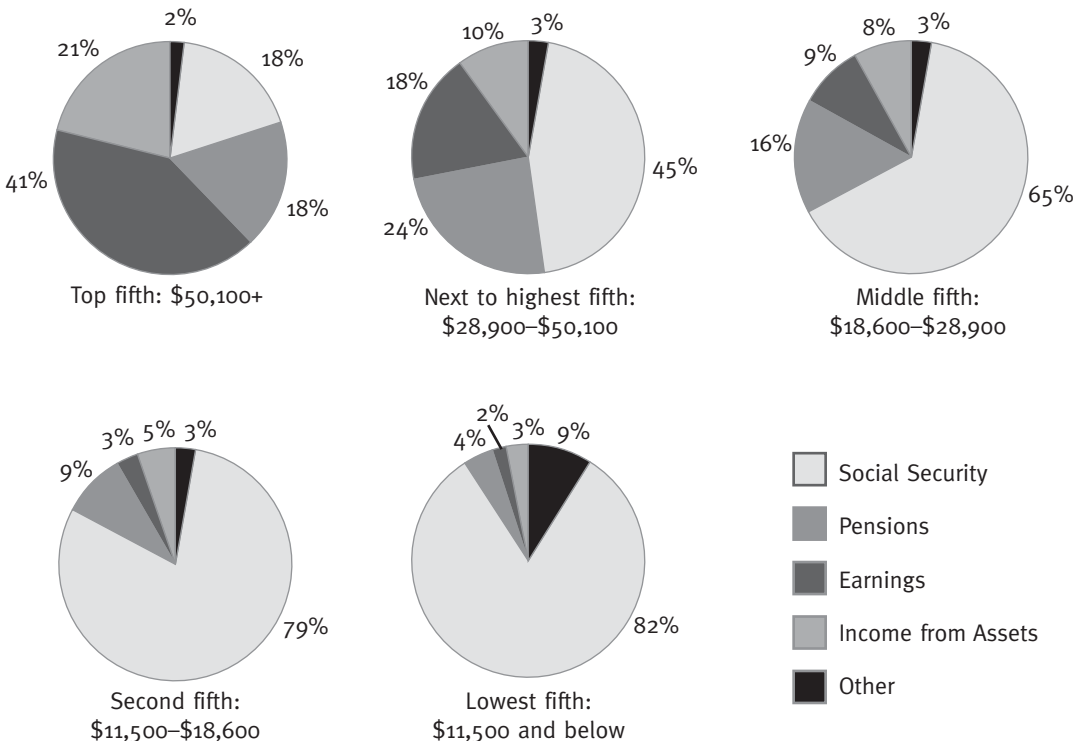
1 Medicare Part B pays for doctors' bills, while Medicare Part A, which is financed through contributions from wages, pays hospital expenses.

2 The increase in the full-benefit retirement age is equivalent to an across-the-board benefit reduction at each age that benefits are claimed. After a beneficiary begins receiving benefits, Medicare premiums rise with the cost of health care, while Social Security benefits rise with the overall cost of living. Because health care cost increases outstrip overall inflation, Medicare premiums will rise faster than Social Security benefits over the long term.

total income from Social Security (SSA 2009b). Elders in the middle group (those with incomes between $18,600 and $28,900) received nearly two thirds of their total income from Social Security, while those in the next-to-highest income group relied on Social Security for nearly half their income. For the highest income quintile (those with income over $50,100), earnings were the largest single source of income because most elders in this top income group were not yet fully retired. In the lower income groups where most elders are fully retired, Social Security is by far the largest single source of retirement income, while pensions ranked second, and asset income was third.

Social Security also provides critical life insurance and disability protection for working families. Those risks are more prevalent than many realize. Social Security Administration actuaries estimate that about 39 percent of young men and 31 percent of young women will die or become disabled before reaching retirement age. For an illustrative young family – a 30-year-old worker earning about $27,000 to $33,000 a year with a spouse and two young children – disability and life insurance protection are each valued at over $450,000 (Nichols 2008).[3] These protections give young adults and children an important stake in Social

Figure 1: Shares of Income from Specified Sources by Income Level, 2006
Married Couples and Unmarried Persons Age 65 and Older



3 The disability and survivor values are determined assuming the worker becomes disabled at age 30 and the worker dies at age 30, respectively.

Security. About 6.5 million children under age 18 receive part of their family income from Social Security. The benefits lift 1.3 million children out of poverty and reduce the depth of poverty experienced by another 1.5 million children (Reno and Lavery 2008).

Private pensions continue to shift away from guaranteed benefits. A long-term shift from defined-benefit pensions to 401(k) plans has placed more financial risks on individual workers. In defined-benefit plans (which predominated 25 years ago), employers typically paid all contributions into the plan, professionals invested and managed the funds, and payments were guaranteed to last for the life of the retiree. Today, most workers with retirement coverage on their jobs have a 401(k)-type plan as their primary or only plan on top of Social Security. In such plans, workers pay some or all contributions and they shoulder the financial risks of poor investment returns; "leakage" from the account when money is withdrawn and spent before retirement; and uncertainty whether the money will last for life (Munnell 2009). This 25-year shift away from guaranteed benefits in private pensions heightens the importance of Social Security for retirees now and in the future.

The financial crisis underscores the importance of Social Security. By exposing the vulnerability of rank and file Americans to the risks of a market economy, the financial crisis shines a new light on the critical role of Social Security. Declining home values, lost savings and corporate pressures to cut pension costs are eroding economic security for current and future retirees. At the same time, job losses, pay cuts, and mortgage foreclosures are further jeopardizing workers' dreams of a secure retirement. Those already retired or near the end of their work lives do not have time to rebuild lost savings. Only Social Security has remained secure and held its value. The increasingly risky environment underscores the key importance of adequate Social Security benefits as a secure foundation of retirement income.

UNDERSTANDING SOCIAL SECURITY FINANCES

While many people consider five or ten years to be long term, ten years is the short-term horizon for Social Security; its long term stretches over 75 years. This valuation period is longer than that used by private pensions or the social security programs of most other countries. Social Security trustees assess its future finances every year using updated assumptions about birth and death rates, wage and price growth, employment, interest rates and other trends that affect Social Security finances. Recognizing the great uncertainty of 75-year forecasts, they project three scenarios: low-cost, high-cost, and intermediate. The intermediate scenario is considered the best estimate and is the most often used.

Who pays for Social Security? Benefits are financed by mandatory contributions paid by workers and matched by their employers, by income taxes paid on Social Security benefits, and by interest on Social Security reserves. The contribution rate for both workers and employers is 6.2 percent of earnings up to a cap ($106,800 in 2009). Self-employed persons pay 12.4 percent (the employee and the employer share) and get a deduction from their personal taxable income for half of the contribution. Covered earnings on which contributions are assessed are called "taxable payroll." High income Social Security

beneficiaries pay income taxes on part of their Social Security benefits, and some of this income tax revenue is dedicated to Social Security.[4] Finally, interest earned on accumulated fund reserves is another source of income. In 2008, interest accounted for 14 percent of income to the system, while income tax revenue on benefits paid by high income beneficiaries accounted for 2 percent, and Social Security contributions paid by workers, employers and the self-employed made up 84 percent (Board of Trustees 2009; Lavery 2009).

What do the Trustees project for Social Security? According to the Trustees' intermediate scenario in the 2009 report:

- Social Security has been running surpluses for 25 years and will have surpluses in each of the next 14 years (2010-2023).
- Reserves are projected to grow to $4.3 trillion by the end of 2023.
- After 2023, reserves will have to be gradually drawn down to pay benefits. By the end of 2037, if no changes are legislated, reserves would be depleted.
- Income coming into the fund after trust fund depletion in 2037 would cover about three fourths of benefit payments.

The long-range actuarial deficit is equal to 2.0 percent of taxable payroll. Closing the 75-year financing gap solely with a contribution rate increase could be accomplished by immediately raising the rate paid by workers and employers from 6.2 to 7.2 percent, which would yield a combined increase from 12.4 to 14.4 percent, or 2.0 percent of taxable payroll. The Trustees are not proposing an immediate tax increase. This summary measure simply shows the size of the long-range deficit in relation to taxable payroll, which is the main revenue base for Social Security. Since Social Security began 74 years ago, Congress has always acted on time to provide additional revenue or scale back future benefits so that all legislated benefits will be paid.

How would policy changes affect long-term finances? Tables 1-3 on pages 28-30 summarize the impacts of various policy options on Social Security's long-term finances. Table 1 shows options that would improve benefit adequacy and their cost as a percent of taxable payroll. Tables 2 and 3 list options that would reduce Social Security's 75-year deficit and their impacts as a percent of taxable payroll. The Office of the Chief Actuary of Social Security provided all the estimates (SSA 2009c). Some estimates are preliminary and might change with more refined analysis.

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4 Part of Social Security benefits are subject to federal income taxes if the beneficiary's taxable income from other sources, plus half of Social Security benefits, exceeds $25,000 for an individual or $32,000 for a married couple filing jointly.

Example of an Illustrative package. The purpose of this report is to help analysts and policymakers consider how Social Security could be put in long-term balance in ways that also address concerns about benefit adequacy. Such a package would need to consider both the cost of improving benefit adequacy and the deficit-reduction impacts of solvency options. We use one of many possible packages in Box 1 to illustrate the process. It starts with the current 75-year deficit of 2.00 percent of taxable payroll. The costs of four adequacy options from Table 1 are added to the deficit. Those options target widowed spouses of low-earning dual earner couples; long-service, low-wage workers who may have gaps in their work due to childcare; students in college or vocational school who have lost parental support due to death or disability; and all beneficiaries, generally. These options, which are described in the rest of this report, would cost about 0.69 percent of taxable payroll, bringing the total shortfall to 2.69 percent of payroll.

Solvency choices include five options selected from Tables 2 and 3: a gradual increase in the Social Security contribution rate for workers and their employers of 1/20 of 1% a year over 20 years for each; a gradual increase in the taxable maximum earnings level; treating other salary reduction plans like 401(k)s for tax purposes; dedicating revenue from an estate tax to Social Security; and gradually lowering the spouse benefit. These five changes would improve Social Security's 75-year balance by about 2.73 percent of payroll.[5] That would be slightly more than enough to close the deficit and pay for the adequacy options in Box 1. Any number of other packages could be assembled. Many variations on options in this report, as well as different options altogether, are possible. The rest of this report describes key features of the individual adequacy options in Table 1, the income-raising options in Table 2, and the benefit-reducing options in Table 3.

5 The combined impact of several options together may not exactly match the sum of the individual options because of the interaction among options. For example, the combined impact of increasing the Social Security contribution rate and increasing the taxable earnings base would be slightly greater than the sum of the impact of each change individually because of interaction.

Box 1: Example of an Adequacy and Solvency Package

Based on Options in Tables 1-3 (pages 28-30)

Option	Description	Percent of Taxable Payroll
	Actuarial balance (75-year deficit)	**-2.00**
	Benefit Adequacy Choices	
2a	Widow(er)s: dual worker, low-earner couples	-0.06[a]
4b	Special minimum with care credits	-0.26
5	Student children of disabled and deceased	-0.07
6c	Increase benefits by 2% in 2010	-0.30
	Total adequacy choices	**-0.69**
	Total adequacy choices plus deficit	**-2.69**
	Solvency Choices	
7c	Gradual rate increase –1/20 of 1%, 2015-2034	1.39
8d	Slowly raise the cap to cover 90% of earnings	0.57
10	Treat other salary reduction plans like 401(k)s	0.25[a]
11b	Dedicate the estate tax to SS (indexed)	0.40[a]
20	Slowly lower spouse benefit from 50% to 33%	0.12
	Total solvency choices	**2.73**
	Net balance (approximate)[b]	**0.04**

[a] These estimates are preliminary and may change with more refined analysis.

[b] The combined impact of several options together may not exactly match the sum of the individual options because of the interaction among options. For example, the combined impact of increasing the Social Security contribution rate and increasing the taxable earnings base would be slightly greater than the sum of the impact of each change individually because of interaction.

Source: Authors' calculations based on estimates for individual options provided by the Office of the Chief Actuary, SSA, based on 2009 Trustees Report assumptions.

Options to Improve Benefit Adequacy

Many of the adequacy options build on ideas in the NASI's report, *Strengthening Social Security for Vulnerable Groups*, which was supported by the Rockefeller Foundation, and on recommendations of the social insurance committee of the Ford Foundation's *Closing the Racial Wealth Gap Initiative* (NASI 2009; Insight Center for Community Economic Development 2009). Some options target economically vulnerable groups such as the oldest old, widow(er)s in old age, low-paid workers (including those with gaps in paid work due to childcare), and students who have lost parental support because of death or disability. Other options provide across-the-board benefit increases. Most options include a brief rationale for the change, how it would work, the source of the proposal, and its impact on long-term finances.

THE OLDEST OLD

Individuals are more likely to become financially vulnerable the longer they live. While younger elders (under age 75) often supplement their retirement income with work, those over 80 rarely do. (More than half of couples age 65-69 have some income from work, but just 4 percent of unmarried elders over 80 do.) Pensions are an important supplement to Social Security for those fortunate enough to have them, but only half of couples and one third of unmarried elders have pension income. Because private pensions rarely keep up with the cost of living, their value erodes over time. With just 3 percent inflation, the value of a $100 non-indexed monthly pension would fall by nearly half after 20 years. Proposals to improve benefits for the oldest old were discussed by Turner (2009) and Dilley (2009) in the NASI report *Strengthening Social Security for Vulnerable Groups*.

Option #1a: Increase Benefits by 5% at Age 85. This option would increase benefits by 5 percent for all beneficiaries age 85 and older in 2010 and for beneficiaries reaching age 85 after 2010. It would cost 0.09 percent of taxable payroll.

Option #1b: Increase Benefits by a Uniform Dollar Amount at Age 85. This option would increase benefits by the same dollar amount for all beneficiaries age 85 and older in 2010 and for beneficiaries reaching age 85 after 2010. The increase would equal 5 percent of the average retired-worker benefit in the prior year. For example, the increase in 2010 would be 5 percent of the average retired-worker benefit of $1,155 in January 2009, or $58

per month. Like the first option, it would cost 0.09 percent of taxable payroll, but it would have a different impact on beneficiaries: while Option 1a would provide a smaller benefit increase to those with smaller benefits, this option would provide the same dollar benefit to all those reaching 85 in a given year.

WIDOWED SPOUSES IN OLD AGE

While retired married couples are rarely poor, widowed spouses (typically women) are. Fully 45 percent of U.S. women living alone after age 65 are poor, according to a widely used international measure of poverty (Smeeding and Sandstrom 2005). Widows may become economically vulnerable for several reasons. When the husband dies, his employer pension may end or decline sharply, and savings may have been depleted to pay for his final illness. Social Security helps bridge the transition from couple to widowed spouse when one spouse depended largely on earnings of the other. But the benefits are less adequate when both the husband and the wife had worked at low pay and both depended on each other's earnings.[6] Entmacher (2009) proposed a benefit increase for such widows and widowers in the NASI's report *Strengthening Social Security for Vulnerable Groups.*

Option #2a: Pay a Widowed Spouse 75% of the Couple's Prior Worker Benefits (with "Average Earner" Cap). This option would pay a new benefit to widowed spouses if the new benefit is higher than that payable under current law. The new benefit would be 75 percent of the sum of the worker benefits received by the two spouses. To target the improvements to low-income couples, the new benefit would be capped at the benefit for a lifelong average earner (about $1,484 for an individual retiring at age 66 in 2009).[7] If the 75-percent benefit option applied to individuals becoming eligible for retired-worker benefits in 2010 and later, it would cost 0.05 percent of taxable payroll. If it also applied to benefits in 2010 for persons already eligible, it would cost 0.06 percent of taxable payroll. These estimates are preliminary and may change with more refined analysis.

Option #2b: Pay a Widowed Spouse 75% of the Couple's Prior Worker Benefits (with "Maximum Earner" Cap). This option is identical to Option 2a, except that it has a

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6 For example, when a couple had depended almost solely on one partner's earnings, the couple receives the workers' retirement benefit, plus a 50 percent supplement for the spouse (150% for the couple). When one spouse dies, the surviving spouse receives an amount equal to that of the retired worker, which is two thirds of the prior benefit of the couple (100%/150%). If both spouses had roughly equal earnings, each would receive his or her own benefits in retirement. When one died, the survivor would receive the higher of their two individual benefits. If both benefits were the same, the survivor's benefit would be half of the couple's prior income.

7 The benefit for an average earner is based on an illustrative work record of a steady worker whose lifetime earnings were about equivalent to the average wage of all workers and who retired at full-benefit age. This benefit is different from (and somewhat higher than) the average retired–worker benefit of all beneficiaries receiving such benefits in a given month.

higher cap. The surviving spouse's benefit (75 percent of the sum of the husband's and wife's worker benefits) could not exceed the benefit for one who had always earned the maximum that is taxed and counted for Social Security benefit purposes (about $2,310 in 2009). If the 75-percent benefit option applied to individuals becoming eligible for retired-worker benefits in 2010 and later, this change would cost about 0.25 percent of taxable payroll. If it also applied to benefits in 2010 for persons already eligible, it would cost about 0.30 percent of taxable payroll. These estimates are preliminary and may change with more refined analysis.

CREDIT FOR CAREGIVING

Because women typically earn less than men, work fewer years, have less in savings, and get smaller pensions, Social Security is essential to their retirement security. Yet, benefits based on women's own work records are often low because women frequently spend part of their adult lives in unpaid work caring for children and other dependents. Various proposals seek to improve benefits by granting Social Security credits for the unpaid work of caregiving. Family care credits were recommended by the *Closing the Racial Wealth Gap Initiative* and by scholars in the NASI's *Strengthening Social Security* project (Favreault 2009; Herd 2009; White-Means and Rubin 2009).

Option #3: Provide Childcare Credits in the Regular Benefit Formula. Former Vice President Al Gore called for this change in his presidential campaign of 2000 (4President.us 2000). It would allow parents credit toward Social Security benefits for up to five years when they have young children. Wage credits for childcare years would be set at one-half of the average wage (about $21,021 in 2009) and would be granted only if a child under age 6 were present. If the parent earned less than the childcare credit, Social Security wage credits would be increased to the childcare credit level. The option to claim childcare credits for past years would be available to individuals becoming eligible for benefits in 2010 or later. Evidence of a child's birth or adoption and the parent's wage record would be used to show eligibility.[8] This change would cost 0.24 percent of taxable payroll over 75 years.

LONG-SERVICE LOW-PAID WORKERS

Individuals who work long careers at low pay are financially vulnerable in retirement. They are far less likely to have earned private pensions during their work lives and have less discretionary income to save. Currently, one who worked full-time at the federal minimum wage and retired at age 62 would get a Social Security benefit that falls about 25 percent

8 The credits would apply to both disabled-worker and retired-worker benefits. Childcare credits could be awarded for past years. Birth or adoption certification and parental identify would suffice as evidence of presence of children. If a beneficiary had more than five years with young children present, the five most advantageous years would be counted. For more information on the Gore proposal, see http://www.4president.us/issues/gore2000/gore2000socialsecurity.htm.

short of keeping him or her out of poverty. Recommendations to keep long-service, low-paid workers out of poverty in retirement come from the *Closing the Racial Wealth Gap Initiative* and the NASI's *Strengthening Social Security* project (Favreault 2009; Insight Center for Community Economic Development 2009; Sullivan, Meschede, and Shapiro 2009). A special minimum benefit was enacted in the 1970s to ensure that low-paid workers who had worked at least 30 years received a benefit that met a basic concept of adequacy. Because this benefit was not indexed to keep pace with wage growth, it does not fulfill that role today.

Option #4a: Update the Special Minimum Benefit to 125% of Poverty at Full-Benefit Age for a 30-Year Worker. This proposal would update the special minimum to pay 125 percent of the poverty threshold for those who worked at least 30 years under Social Security and claimed benefits at full-benefit age (currently age 66). If such a proposal had been in effect in 2009, a 30-year worker would receive about $13,540 per year ($1,128 per month) if he or she claimed benefits at age 66. At age 62, the benefit would be $846 per month or about $10,500 per year, which is close to the poverty line. This special minimum benefit would be paid only if it were higher than the benefit payable under the regular benefit formula. As with all other Social Security benefits, initial benefits for each age cohort would keep up with wage growth, and benefits after entitlement would be adjusted automatically to keep up with the cost of living.[9] This option, effective for individuals newly eligible for benefits in 2010 and later, would cost 0.13 percent of taxable payroll over 75 years.

Option #4b: Update the Special Minimum and Allow Childcare Credits. This proposal is like Option 4a, with the additional feature that years in which a parent had a young child could count as a year of coverage. A parent could receive a childcare credit year when a child under age 5 is present, with a maximum of 8 such childcare years.[10] If this new special minimum benefit were first available to persons becoming eligible for benefits in 2010 or later, it would cost 0.26 percent of taxable payroll over 75 years.

STUDENTS WHO HAVE LOST PARENTAL SUPPORT

Social Security pays benefits to children until age 18 (or 19, if still attending high school), if a working parent has died, become disabled, or retired. In the past those benefits continued

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9 Details of the proposal include: (a) four quarters of coverage would count as a year of coverage; (b) the benefit for 30 years of coverage at full benefit age would be 125% of the poverty threshold; (c) initial benefits for each cohort would be adjusted by wage growth; and (d) the benefit would be calculated as under present law, such that 20 years of coverage after the first 10 years produce the maximum special minimum benefit. The new benefit would be effective for persons newly eligible in 2010 and later.

10 The childcare credits could be documented by a birth or adoption certificate and with evidence of parental identity. The childcare credit would be available to both parents. Evidence of past childcare years would count. The new benefit would be effective for persons newly eligible in 2010 and later.

until age 22 if the child was a student in college or vocational school. Congress ended student benefits in 1981. Research shows that student benefits helped low-income children move up the economic ladder. Recipients disproportionately had parents in blue-collar jobs, were African American, and had lower family incomes than other college students (Springer 1976). The *Closing the Racial Wealth Gap Initiative* recommended restoring Social Security benefits for students until age 22.

Option #5: Restore Student Benefits. This proposal would continue benefits for children of disabled or deceased workers until age 22 when the child is in high school, college or vocational school. The continuation of benefits while children are students would replace part of parental support that was lost due to death or disability. To the extent that benefits help students increase their future earning power, the change could have some positive effect on the broader economy (and the Social Security system). Ignoring these partial offsets, the change would cost 0.07 percent of taxable payroll over 75 years.

ACROSS-THE-BOARD BENEFIT INCREASES

The recent financial crisis and prolonged economic recession expose the vulnerability of average Americans to the risks of a market economy. Seniors and those nearing retirement do not have enough time to restore lost savings. James Galbraith (2009) recommended across-the-board increases in Social Security to partially offset losses elsewhere, and Nancy Altman (2009) developed a plan to provide an across-the-board benefit increase by integrating a new tier of retirement income directly into the Social Security system. Three options are illustrated here.

Option #6a: Increase Benefits by 20%. This option would increase benefits by 20 percent for all individuals eligible for Social Security as of 2010, and for those becoming eligible after 2010. If it applied in 2009, the average annual Social Security benefit income for retired workers would increase from about $13,860 to about $16,630. It would cost 2.98 percent of taxable payroll over 75 years.

Option #6b: Increase Benefits by 5%. This change would increase benefits by 5 percent for all individuals eligible for Social Security as of 2010, and for those becoming eligible after 2010. If it applied in 2009, the average annual Social Security benefit income for retired workers would increase from $13,860 to $14,550. It would cost about 0.75 percent of taxable payroll over 75 years.

Option #6c: Increase Benefits by 2%. This change would increase benefits by 2 percent for all individuals eligible for Social Security as of 2010, and for those becoming eligible after 2010. If it applied in 2009, the average annual Social Security benefit income for retired workers would increase from $13,860 to $14,137. It would cost about 0.30 percent of taxable payroll over 75 years.

Options to Increase Income for Solvency

Balancing Social Security finances over the next 75 years will require some combination of raising more revenue or lowering some benefits. Revenue-raising options include raising the contribution rate that workers and employers now pay on wages or broadening the sources of income to pay for Social Security.

INCREASE THE SOCIAL SECURITY CONTRIBUTION RATE

Since the early years of the program, Social Security has been financed largely by mandatory contributions from workers and employers, authorized under the Federal Insurance Contributions Act of 1939 (FICA). The act established a link between the source of funding and the purpose of the program, which was to insure against economic insecurity when wages are lost due to old age, death of a family worker, and, later, disability. There are many ways to schedule future Social Security contribution rates to match a desired stream of benefits. The first option illustrates how policymakers might close the 75-year shortfall in one immediate action. Other options are more gradual or seek to match new funds with the need for them in the future.

Option #7a: Immediately Raise the Social Security Contribution Rate by 1.1% for Workers and Employers. If policymakers raised the Social Security contribution rate, starting in 2010, so that workers and employers each paid 7.3 percent instead of 6.2 percent of earnings, the deficit would decline by 2.09 percent of taxable payroll, which is slightly more than enough to make Social Security solvent for 75 years. A medium-wage worker, making $43,451 in 2010, would face a tax increase of $478 a year, or $9.19 a week, and the employer would face an identical increase. Because Social Security will run surpluses during the next decade, an immediate rate increase would add to the surpluses that are invested in Treasury securities and, in that way, loaned to the rest of the government.

Option #7b: Schedule Future Contribution Rate Increases When Funds Will Be Needed. Because Social Security does not need more money immediately, policymakers could address the long-term shortfall by acting now to schedule rate increases out in the future when the funds will be needed. Rate increases scheduled in the future were part of Social Security from its inception in 1935 up through 1990. Such scheduled rates can

balance long-range finances and allay concerns that Social Security will not pay legislated benefits. If the funds turn out not to be needed, future Congresses could reduce or rescind the change. Thompson (2005) made a case for this approach on grounds of fairness. Using the trustees' official projections, he found that workers will enjoy rising standards of living, while retirees will not keep up after paying more out of pocket for health care. He concluded that it would be more equitable to balance Social Security finances by raising the contribution rate for future workers than by reducing benefits for future retirees. Future workers could afford to pay more out of their rising real wages in order to preserve present law benefits for retirees. Future retirees, in contrast, would fall even further behind if benefit cuts were part of the solvency plan.

As one example of this approach, policymakers could act now to schedule a two-step increase in the Social Security rate: from 6.2 to 7.2 percent for workers and employers in 2022, and to 8.2 percent in 2052. This option would eliminate the 75-year deficit. By 2022, workers' real wages – that is, their purchasing power after adjusting for inflation – would be about 16 percent higher than in 2009. If 2 percent more of their wages went to pay for Social Security, they would still be 14 percent richer than today's workers. By 2052, wages are projected to have 56 percent greater buying power than in 2009 (Board of Trustees 2009).

Option #7c: Schedule a Very Gradual Contribution Rate Increase Over 20 Years. To avoid abrupt changes in Social Security contribution rates, this option would schedule very gradual increases in the Social Security contribution rate (one-twentieth of one percent per year over 20 years for employees and employers, each), beginning in 2015. By 2035, the Social Security rate would be 7.2 percent for both workers and employers. In 2015, the increase for an average earner making $53,085 then would be $26.50 a year, or about 50 cents a week. It would reduce the 75-year deficit by 1.39 percent of taxable payroll or by about 69 percent. Dale Coberly, a frequent commenter on Social Security, recommended a gradual tax increase of this sort (Coberly, Larson and Webb 2009).[11]

Option #7d: Schedule a Future "Balancing Rate" Increase. Acknowledging the uncertainty of 75-year projections, former Social Security Commissioner Robert M. Ball (2007) proposed a balancing rate increase that would be adjusted as future estimates change. The balancing rate would be based on the trustees' most current intermediate assumptions, but it would be clearly understood and clearly communicated to the public that this rate would need to be adjusted up or down over time. The balancing rate would be

11 Dale Coberly is a student of Social Security policy and frequent commenter on Social Security via the blog Angry Bear. Angry Bear was named one of the top 25 independent economic blogs on the Internet by the Wall Street Journal and TimeCNN. Coberly, Arne Larson and Bruce Webb collaborated on a modified version of this option in their Northwest Plan. For details of the Northwest Plan, see "The Angry Bear Social Security Series" at http://bruceweb.blogspot.com/2008/08/angry-bear-social-security-series.html.

a fail-safe provision to take effect automatically if Congress did not adjust revenues and costs to changes in the estimates. When long-range forecasts change, the future fail-safe rate would be automatically adjusted to prevent the trust funds from declining and maintain financing for the balance of 75 years.[12]

Revenue-raising alternatives to increasing Social Security tax rates include broadening the contribution base and dedicating other funds to Social Security.

WHY CONSIDER BROADER SOURCES OF INCOME?

Most of national income is not part of the contribution base that is now tapped to pay for Social Security. Wages subject to Social Security contributions amount to 39 percent of national income, or gross domestic product (GDP) (Board of Trustees 2009). Because almost everyone benefits from Social Security, broadening sources of income would help share the future cost more equitably among all Americans. Moreover, many of the sources that are not taxed to pay for Social Security go disproportionately to upper income individuals. Sources of income not taxed to help pay for Social Security include:

- Earnings above the tax cap (about 17 percent of aggregate earnings);
- Earnings of workers not covered by Social Security (about 25 percent of State and local government employees do not to participate in Social Security);
- Non-taxable fringe benefits paid by employers, such as health insurance premiums, pension and 401(k) contributions, and most other employee benefits;
- Employees' tax-favored contributions to "salary reduction" plans for purposes other than retirement (such as out-of-pocket spending for health care, child care, or work expenses);
- Income from capital, such as interest on investments, stock dividends, and rental income from real estate; and
- Realized increases in the value of property (capital gains) and transfers of property (through gifts and inheritance).

The Social Security tax base is projected to decline from 39 to 33 percent of GDP over the next 75 years due largely to the assumption that non-taxable employer contributions for employee health insurance will be a rising share of employee compensation (Board of Trustees 2009, Table VI.F5). Options that would broaden the revenue base for Social Security include raising or eliminating the cap on earnings subject to Social Security taxes; expanding coverage to non-covered workers; and treating other salary-reduction plans like 401(k)s for Social Security contribution purposes. Other ways to increase income for Social Security

12 This option was, in his view, a fail-safe mechanism in the event that his package of three reforms turned out to be insufficient to solve the program's projected financing shortfall.

include dedicating other taxes to Social Security, such as the estate tax or a new surtax on income of high-income households, and diversifying investments to earn higher returns for Social Security trust funds.

RAISE THE TAX CAP

In 2009, only earnings up to $106,800 are taxed and counted toward workers' future Social Security benefits. About 6 percent of all workers earn more than the cap. The cap is indexed to keep pace with the growth in average earnings of all workers. In the past, Congress set the level of the cap to cover 90 percent of the aggregate wages of all workers (Altman 2005). Today, it covers only about 83 percent of such earnings (Romig and Mulvey 2009). The decline occurred because those at the top of the economic ladder (who make more than the cap) have enjoyed more rapid growth in earnings than those who make less than the cap. One who always earned the maximum amount and retired at age 65 in 2009 would receive $2,172 per month, or about $26,000 per year in Social Security benefits. The benefit replaces about 25 percent of that worker's taxable earnings (Board of Trustees 2009, Table VI.F10). The following options to lift the tax cap differ in how they phase in and whether and how the additional taxable earnings would count toward workers' future benefits.

Option #8a: Eliminate the Cap – Do Not Count the Additional Earnings toward Benefits. If all earned income above $106,800 a year were subject to Social Security contributions, but those earnings did not count toward benefits, Social Security would be solvent throughout the long-range projection period. Making this change in 2010 would be more than enough to eliminate the 75-year deficit. With this change, workers who earn far more than the tax cap would pay considerably more in taxes. For example, a person making $400,000 per year would pay $18,178 per year more and his or her employer would pay a matching amount, for a total increase of $36,356. The worker's maximum benefit would be no higher than under current law. Ever since Social Security began, all wages that are taxed have counted toward benefits. This proposal would break that traditional link.[13]

Option #8b: Eliminate the Cap – Count the Earnings toward Benefits. If all wages above $106,800 in 2009 were taxed and counted toward benefits, the change would almost make Social Security solvent through the long-range period, eliminating about 95 percent of the 75-year shortfall. While high earners and their employers would pay considerably more, these top earners would also receive much higher benefits. For example, one who had paid taxes on lifetime annual earnings of $400,000 would get a benefit of about $6,000 per month, or $72,000 per year, which would replace about 18 percent of the worker's average earnings. One who had average lifetime earnings of $1.0 million per year would get a monthly Social Security benefit of about $13,500, or $162,000 per year, which would

13 Designers of the Social Security program viewed Social Security taxes as insurance premiums to replace wages when one can no longer work due to disability, death, or old age.

replace about 16 percent of that worker's average earnings. These estimates assume that the existing benefit formula would apply to all earnings above $106,800. A traditional rationale for having a maximum cap on earnings that count toward benefits is to avoid very high benefits (Altman 2005; Advisory Council on Social Security 1979).

Option #8c: Eliminate the Cap – Count Earnings toward Benefits with a Flatter Formula. If all earnings above the cap were taxed and counted toward benefits, policymakers could decide to change the benefit formula to replace a smaller portion of earnings above the old cap as a way to avoid paying very high Social Security benefits. The current formula is based on workers' average indexed monthly earnings (AIME) in three brackets. In 2009, Social Security pays:

90 percent of AIME up to $744, plus

32 percent of AIME between $744 and $4,482, plus

15 percent of AIME over $4,482

A modified formula might apply the 15 percent bracket only up to the old cap, and then provide a smaller replacement, say 3 percent of earnings, above that. For example, the third part of the above formula could be modified to:

15 percent of AIME between $4,482 and $8,900 ($106,800 divided by 12), plus

3 percent of AIME over $8,900

With this change, a worker with average lifetime earnings of $1.0 million a year would receive a benefit of $5,028 a month or $60,342 a year (instead of $162,000). This option, starting in 2010, is estimated to eliminate the 75-year deficit, resulting in savings of 2.17 percent of payroll.

Option #8d: Very Gradually Restore the Cap to Cover 90% of Earnings. This option would very gradually increase the taxable earnings base to include 90 percent of earnings by increasing the base by 2 percent per year above the growth in average wages. For example, the maximum taxable base in 2010 would go up $2,136 (2 percent of $106,800) beyond the automatic increase. In practice, this would mean that deductions from earnings for the highest-paid 6 percent of workers would continue for a few days longer into the year (and for their additional contributions they would receive somewhat higher benefits). For the 94 percent of covered workers with earnings below the cap, there would be no change at all. Nancy Altman (2007; 2005) recommended this approach, as did Robert M. Ball (2004). The change would bring the taxable maximum to the 90-percent level in about 36 years and would reduce the 75-year deficit by 0.57 percent of taxable payroll.

Option #8e: End the Cap for Employers and Gradually Lift the Cap to Cover 90% of Earnings for Employees. This option would eliminate the cap entirely for employers while gradually lifting the cap to encompass 90 percent of wages for employees (as in Option 8d). All

of employees' taxable earnings would be counted toward benefits. Covered employers would pay Social Security contributions on their entire payroll (as they now do for hospital insurance under Medicare). The rapid growth in earnings at the top of the wage distribution might justify subjecting all wages to Social Security contributions. This option would reduce the long-range deficit by about 1.43 percent of taxable payroll, or by just over seven tenths. This estimate is preliminary and may change with more refined analysis.

EXTEND COVERAGE

Almost all workers pay into Social Security. The main exception is the roughly 25 percent of State and local government employees who are covered by alternative pension systems and are not provided Social Security coverage (U.S. Committee on Ways and Means 2004). When Congress last extended coverage in 1983, it brought all newly hired federal employees into Social Security but did not extend that requirement to non-covered State and local employees.[14] Congress did, however, end the option for allowing states that provided Social Security coverage to drop that coverage.

Option #9: Extend Social Security Coverage to Newly-Hired Non-covered State and Local Government Employees. Many advisory groups have recommended this change to achieve more nearly universal coverage under Social Security and to provide seamless coverage for workers who change jobs (Advisory Council on Social Security 1997; National Commission on Retirement Policy 1998). States with more than half their state and local employees not covered by Social Security include: Ohio; Massachusetts; Louisiana; Nevada; Colorado; California; Alaska; and Maine (U.S. Committee on Ways and Means 2004). State and local governments that would be affected and their employee representatives have opposed this idea in the past. They would be required to pay Social Security taxes and they would need time to modify their pension systems to fit with Social Security, as was done for newly-hired federal employees after 1983. If all newly-hired State and local employees were brought into Social Security coverage during a five-year phase-in period, this change would reduce the 75-year deficit by 0.17 percent of payroll or by about 9 percent. The slight improvement in finances occurs because the newly-covered workers and employers start to pay into Social Security immediately. Ultimately, the workers will also receive benefits.

TREAT ALL SALARY REDUCTION PLANS LIKE 401(K)S

Under the 1983 amendments to Social Security, employees pay Social Security and Medicare taxes on their contributions to retirement accounts, such as section 401(k), 403(b) and 457 plans, but they do not pay Social Security and Medicare taxes on their payments into other

14 Following the 1983 legislation, a new Federal Employees Retirement System was set up to supplement Social Security coverage for newly-hired federal employees. Employees hired before 1984 could elect to join the new system and be covered by Social Security or to remain in the older Civil Service Retirement System. The number of federal employees not covered by Social Security is gradually declining.

types of salary reduction plans, or "flexible spending accounts." These are accounts that employers set up to allow their workers to exclude from taxable income out-of-pocket spending for health care, dependent care, or qualified commuting costs for parking, van pooling, or transit fares (Joint Committee on Taxation 2005). Employee contributions to both 401(k)s and other flexible spending accounts are exempt from personal income taxes for employees.

The legislative rationale for keeping 401(k) contributions subject to Social Security and Medicare taxes was to assure that such plans are not used to avoid Social Security tax liability and that employees get Social Security protection based on those wages (SSA 2009d). This rationale applies equally to salary reduction plans used for other purposes (Joint Committee on Taxation 2005). Exempting employee payments into flexible spending accounts from Social Security and Medicare taxes means that the respective trust funds are deprived of both the employee contributions and the employers' matching share of Social Security and Medicare contributions.

Option #10: Treat All Employee Payments into Salary Reduction Plans Like 401(k)s. Treating all employee contributions into salary reduction plans like 401(k) contributions for Social Security and Medicare contribution purposes would reduce the 75-year deficit in the Social Security program by 0.25 percent of taxable payroll. This estimate is preliminary and may change with more refined analysis.

USE PROGRESSIVE TAXES TO COVER SOCIAL SECURITY'S LEGACY COSTS

While supportive of maintaining the payroll tax (contributions on wages) for Social Security, some social insurance experts argue for using a more progressive source of income to pay for a particular part of Social Security's costs – that is, the so-called legacy costs that arose from providing for the common good in the early years of the program (See Box 2). Such proposals include dedicating an estate tax to Social Security, levying a new legacy tax on earnings above the tax cap, and levying a legacy tax on high-income households.

Options #11a & b: Dedicate Estate Tax Revenue at the 2009 Level to Social Security. Economists Peter Diamond and Peter Orszag (2003) first suggested dedicating the estate tax to cover part of Social Security's legacy cost. Robert M. Ball (2007) also advocated this change. He argued that

> *a modest tax on large estates to help pay off the cost of establishing a universal system of basic economic security would be a highly progressive way to partially offset the legacy cost. Moreover, to allow the transfer of huge estates from one generation to another without requiring a contribution to the common good is undemocratic in principle (as Tom Paine, among other early advocates of an estate tax, recognized). Although the accumulation of large estates may in many cases be largely attributable to the hard work of the estate owners, wealth also derives from the general productivity of the American economy and its infrastructure. Thus a tax for the common good is a reasonable payback for the common contribution to estate building.*

Box 2: What Are Legacy Costs?

Social Security contributions were first collected from workers and employers in 1937 and benefits were first paid in 1940. The decision to pay benefits to retirees in the early years that far exceeded the value of the contributions that they and their employers had had time to make created a deficit of contributions or "legacy cost" that future generations would have to face (Ball 2007). Virtually all observers agree that the decision to pay full benefits to the early beneficiaries was a wise one (Munnell 2009b). Many of those beneficiaries had fought in World War I, endured the economic devastation of the Great Depression, and sacrificed during World War II. Paying these benefits reduced high rates of poverty and relieved part of the burden on families that would otherwise have had to provide more direct support to their aging parents and relatives (Diamond and Orszag 2003). In essence, Social Security costs can be divided into two parts – the funds necessary to pay for current benefits and the funds required to cover legacy costs. While workers' and employers' contributions from wages are designed to cover the first type of costs, more progressive taxes on a broader tax base could be justified to cover "legacy costs" that were incurred to provide for the common good in the early years.

In 2009, the estate tax applies only to the value of an estate in excess of $3.5 million if it is not left to a surviving spouse, who can inherit all assets tax-free.[15] Values above that level not inherited by a spouse are taxed at 45 percent, with 55 percent going to non-spouse heirs. The estate tax is slated to fall to zero in 2010, and then revert to the higher tax rates applicable in 2001 (a 55 percent tax on estates over $1 million for individuals and $2 million for couples). Preserving the estate tax into the future and dedicating the revenue from the tax with the 2009 level of exclusion and tax to Social Security would reduce the long-term deficit by 0.51 percent of payroll, thereby eliminating about one fourth of the deficit.[16] This estimate assumes that the estate tax threshold for Social Security revenue will remain $3.5 million for all future years. If the amount of the estate tax exemption rose with the consumer price index, this option would reduce the 75-year deficit by 0.40 percent of payroll or about one fifth of the deficit. These estimates are preliminary and may change with more refined work.

Option #12: "Legacy" Tax on Earnings Above the Tax Cap. Diamond and Orszag (2003) recommended a 3 percent legacy tax on earnings above the taxable earnings cap as a way to ensure that very high earners contribute to financing Social Security's legacy cost in proportion to their full earnings. If a 3 percent legacy tax on earnings above the tax cap began in 2010

15 Each member of a couple can leave $3.5 million to non-spouse heirs without incurring any tax liability, thus shielding from taxation married couples' estates valued up to $7 million.

16 If Congress allowed the estate tax to return to its higher 2001 level in 2011, then this option would use part of estate tax revenue to pay for Social Security and part would go to general revenues.

(1.5 percent for workers and employers each) and the higher earnings did not count toward benefits, the long-term deficit would be reduced by 0.57 percent of taxable payroll, or by a little over one fourth. This option was presented in the AARP report, *Building a Sustainable Future* (2008).

Option #13a: Dedicate to Social Security a 3% Legacy Tax on Adjusted Gross Income (AGI) over $250,000 for Couples and $125,000 for Individuals. This option differs from Option 12 in that it uses the personal income tax to dedicate new revenue to Social Security. The income tax has a broader base than the Social Security tax in that it taxes income from wealth as well as income from work. Dedicating to Social Security a 3 percent legacy tax on AGI over $250,000 for couples and $125,000 for individuals starting in 2010 would reduce the 75-year deficit by 0.74 percent of taxable payroll, thereby reducing the deficit by just over one third, assuming the thresholds were indexed by average wage growth. This estimate is preliminary and may change with more refined analysis.

Option #13b: 5% Legacy Tax on AGI. Dedicating to Social Security a 5 percent legacy tax on AGI over $250,000 for couples and $125,000 for individuals would reduce the 75-year deficit by 1.23 percent of taxable payroll, thereby eliminating roughly six tenths of the deficit. This estimate is preliminary and may change with more refined analysis.

MAINTAIN RESERVES AND DIVERSIFY INVESTMENTS

As part of a Social Security financing strategy, Robert M. Ball (2007) called for building up and maintaining large reserves so that investment income would remain a permanent source of support for Social Security. Those who advocate permanent reserves often propose a more diversified investment plan for the funds as well. Instead of investing only in special-issue Treasury securities, part of the funds would be invested in bonds or equities that have higher expected returns over the long term. Ball called for investing part of the funds in equities, "as is done by just about all other public and private pension plans." He observed that several other government pension programs, such as those for employees of the Federal Reserve System, the Tennessee Valley Authority, and U.S. railroads already make such direct investments in stocks, as does the Canadian social insurance system.

Option #14a: Gradually Invest 15% of Trust Fund Assets in Equities. This option would gradually invest 15 percent of trust fund assets in a broad index of equity market securities, such as the Wilshire 5000. It would increase the portion of trust funds invested in equities by 1.5 percent a year for 10 years and would maintain equity investments at 15 percent thereafter. This change was presented in the AARP report, *Building a Sustainable Future* (2008). It would reduce the long-range deficit by 0.27 percent of taxable payroll, assuming an average yield on equities of 6.4 percent above inflation (3.5 percentage points over the expected average yield on long-term Treasury bonds) (SSA 2009e).

Option #14b: Gradually Invest 40% of Trust Fund Assets in Equities. This option would gradually invest 40 percent of trust fund assets in equities, phased in over 15 years

(between 2010 and 2024). The funds would be invested in a broad index of equity markets. Assuming the funds earn an historical 9.4 percent return (or 6.4 percent real return over 2.8 percent inflation[17]), this change would reduce the long-term deficit by 0.67 percent of payroll, thereby eliminating about one third of the long-range deficit. If, instead, the same investment policy ended up producing a nominal return of 8.4 percent (or a real return of 5.4 percent on top of inflation), the policy would reduce the long-term deficit by 0.48 percent of taxable payroll, thereby eliminating about one fourth of the long-term deficit. If one assumes that the investment earns the same return as Treasury bonds (2.9 percent real) there would be no impact on the 75-year deficit.

17 The nominal 9.4 percent return is the product of (1 + the inflation rate) times (1 + the real return) or 1.028 x 1.064 = 1.0938.

Options to Reduce Benefits for Solvency

Options that would lower future benefits to balance long-term finances include those that would reduce the annual cost-of-living adjustment (COLA), increase the age for receiving full retirement benefits, lengthen the average period used to calculate lifetime earnings, lower benefits for new beneficiaries and lower the benefit payable to spouses of retired workers.

REDUCE THE COST-OF-LIVING ADJUSTMENT

Under current law, Social Security benefits are automatically adjusted each year to keep up with the cost of living as measured with the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). Some proposals would lower Social Security benefit costs by changing the way in which Social Security benefits are adjusted to keep pace with inflation. Some proposals would pay less than the full COLA, for example, by adjusting benefits by the COLA minus 1 percent, or minus ½ of 1 percent. Another would shift to a new index.

Option #15a: Reduce the COLA by 1% each year. If the annual COLA increase for Social Security beneficiaries were reduced by 1 percentage point, the long-term deficit would decline by 1.55 percent of taxable payroll. If inflation were 2.8 percent per year (as assumed by the Trustees), the annual increase for beneficiaries would be 1.8 percent per year. This change would impose the greatest burden on the oldest beneficiaries because the reductions accumulate over time. For example, a 92-year-old beneficiary would have the purchasing power of her or his benefits eroded by 25 percent if the cost of living went up by 2.8 percent every year, but (s)he received only a 1.8 percent increase each year.

Option #15b: Reduce the COLA by ½% each year. If policymakers were to reduce the COLA by half a percentage point, the change would reduce the long-range deficit by 0.81 percent of taxable payroll, thereby eliminating just over one third of the shortfall. In this scenario, a 92-year-old beneficiary who started receiving benefits at age 66 would see the purchasing power of her/his benefits eroded by 14 percent if inflation were 2.8 percent per year, but she or he received only a 2.3 percent annual increase.

Option #15c: Adopt the "chained" Consumer Price Index (CPI). A different approach would shift to a new measure of the cost of living. Social Security benefits are now

automatically adjusted by changes in the CPI-W, as measured by the Bureau of Labor Statistics (BLS). The BLS has developed a new "chained" CPI. It differs from the CPI-W in that it takes into account purchasing substitutions across broad categories of goods and services (such as spending less on food to pay for higher-priced gasoline). Because the "chained" CPI is expected to increase about 0.3 percent slower each year than the CPI-W, this change would reduce the long-run deficit by 0.49 percent of taxable payroll, thereby shrinking the shortfall by nearly one-fourth. Proponents of this approach argue that the chained CPI is a more accurate and up-to-date measure of the cost of living. Opponents point out that, while it may be more accurate for the general population, it may be less accurate for seniors who spend a larger share of their incomes on health care. To the extent that the chained CPI understates increases in the cost of living for beneficiaries, the oldest beneficiaries would be most affected, as would be the case with all COLA reductions.

INCREASE THE AGE FOR FULL RETIREMENT BENEFITS

The age at which retirees can collect full Social Security benefits is now 66 years for people born in 1944 (who reach 65 in 2009). It is scheduled to rise to 67 for those born in 1960 or later. Raising the full benefit age would improve Social Security's long-range finances because it would further lower benefits for all future retirees. For example, when the full benefit age was 65, benefits starting at age 62 were reduced by 20 percent; when the full-benefit age reaches 67, benefits starting at 62 will be reduced by 30 percent, while benefits taken at age 65 will be reduced by 13.3 percent. Proponents of increasing the full benefit age believe that retirement ages should rise as people are living longer. Opponents point out that Social Security's full-benefit age (67 in the near future) is already much older than eligibility ages in private (or public) pension plans, which remain 65 or earlier. Moreover, it is older than the ages for penalty-free withdrawals from 401(k)s or IRAs (59 ½).

Option #16a: Accelerate the increase to 67; then increase the full-benefit age by 1 month every 2 years to age 68. If policymakers speed up the increase in the full-benefit retirement age to reach 67 for those born in 1953 or later, and raise the age one month every two years until it reaches age 68 for people born in 1977 and later, these changes are estimated to reduce the long run deficit by 0.46 percent of taxable payroll, thereby eliminating just under one fourth of the long-term deficit. Under this change, when the full-benefit age is 68, benefits starting at age 65 would be reduced by 20 percent and benefits starting at age 62 would be reduced by about a third.

Option #16b: Accelerate the increase to 67; then increase the full-benefit age by 1 month every 2 years to age 70. This option would continue to increase the full-benefit age to 70. If policymakers speed up the increase in the full-benefit retirement age to reach age 67 for those born in 1953, and then extend it one month every two years until it reaches age 70 for people born in 2025, these changes would reduce the long-term deficit by 0.62 percent of taxable payroll, thereby eliminating just under one third of the long-range shortfall. With this change, the benefit reduction for early retirement would be larger.

When the full-benefit age reached 70, benefits starting at age 65 would be reduced by 30 percent and benefits starting at age 62 would be reduced by 43 percent.

Option #16c: Gradually index the full-benefit age for longevity indefinitely. After the full-benefit age reaches 67 for those born in 1960, the full-benefit age would increase by one month every two years for those born after 1960. It would increase to age 68 for those born in 1984, to 69 for those born in 2008 and to age 70 for individuals born in 2032. This schedule roughly matches assumptions about increasing life expectancy for people reaching age 65 in the future. This change would reduce the long-run deficit by 0.37 percent of taxable payroll, thereby eliminating about one sixth of the long-term shortfall. This change was included in AARP's 2008 report, *Building a Sustainable Future*.

LENGTHEN THE CAREER-EARNINGS AVERAGING PERIOD

To calculate Social Security benefits, a worker's earnings are indexed to a recent average-wage level so that earnings at the beginning of one's work life are stated in the same dollars as earnings in later years. The highest 35 years of those "indexed" lifetime earnings are then converted into a worker's Average Indexed Monthly Earnings (AIME) by dividing the total by 420 (number of months in 35 years). A worker's Social Security benefit is calculated by applying the "primary insurance amount" formula to the AIME. Increasing the number of work years for calculating average lifetime earnings will lower future benefits because the additional years of earnings included in a worker's average lifetime earnings will be lower than each of the 35 years now used. This reduction would have the greatest impact on individuals with gaps in their paid work records or individuals who spent part of their work lives not covered by Social Security because the additional years included would likely be years with zero earnings. It would have a small impact on individuals who had steady and consistent covered work records of 38 or 40 or more years of work.

Option #17a: Increase the averaging period from 35 to 38 years. An increase in the number of years used to calculate average lifetime earnings for retirement and survivor benefits (but not for disabled workers) from 35 to 38, phased in from 2010 – 2014, would reduce the long-term deficit by 0.29 percent of taxable payroll, thereby shrinking the shortfall by about 14 percent.

Option #17b: Increase the averaging period from 35 to 40 years. Lengthening the averaging period to 40 years, phased in between 2010 and 2018, for retirement and survivor benefits (but not for disabled workers) would reduce the long-term shortfall by 0.46 percent of taxable payroll. It would shrink the shortfall by about one-fourth.

REDUCE BENEFITS FOR NEW BENEFICIARIES

Two options, below, illustrate the impact of immediate across-the-board reductions in benefits for new beneficiaries, while a third option gradually phases in reductions that

exempt those with very low lifetime earnings. A fourth option gradually scales back benefits for dependent spouses (but not widowed spouses) of retired workers.

Option #18a: Reduce benefits by 3% for new beneficiaries in 2010 and later. If benefits were reduced by 3 percent for everyone newly eligible in 2010 or later, this change would reduce program costs by 0.36 percent of taxable payroll, thereby reducing the 75-year deficit by just under one-fifth. This change would lower benefits for all new recipients, including retirees and their dependents, widowed spouses, disabled workers and their families, and families with children whose working father or mother died.

Option #18b: Reduce benefits by 5% for new beneficiaries in 2010 and later. If benefits were reduced by 5 percent for everyone newly eligible for benefits in 2010 or later, this change would reduce program costs by about 0.61 percent of taxable payroll, thereby lowering the long-range deficit by about three tenths.

Option #19: Price index benefits for successive generations beginning in 2013. Under current law, benefits for each successive age cohort (or generation) of new beneficiaries are indexed to keep pace with average-wage growth. The rationale for doing so is to provide stable replacement rates for future retirees across generations, so that benefits for an average earner retiring at full-benefit age in any future year would replace the same portion of career earnings as for today's retirees. After entitlement, benefits are automatically adjusted to keep pace with price growth (inflation), with the aim of maintaining beneficiaries' purchasing power. A variety of options would gradually lower future benefit levels by indexing benefits for newly eligible retirees across generations by price growth instead of the higher average-wage growth. Many such plans would exempt the lowest earning retirees from the benefit reductions. Senator Bob Bennett of the Joint Economic Committee introduced one such plan (S. 426 in 2009), which would exempt from benefit reductions retirees in the bottom 30 percent of career average earnings (about $23,500 in 2009). Retirees above that level in future generations would gradually receive lower benefits, with the greatest reduction affecting the highest earners. In 2059, benefits for a steady maximum earner (making $106,800 in 2009) at age 65 would be 38 percent lower than scheduled in current law. Benefits for a "high" earner (making about $67,270 in 2009) would be about 32 percent lower, while for an average earner (making about $42,040 in 2009) the benefit would be about 22 percent lower. This change would reduce long-range costs by about 1.31 percent of taxable payroll, or by just under two-thirds of the long-range deficit (SSA 2009f).

Option #20: Gradually lower the supplemental spouse benefit. Under current law the spouse (age 62 or older) of a retired or disabled worker can receive a benefit of up to 50 percent of the primary worker's benefit, but only to the extent the benefit exceeds what the spouse is entitled to based on her or his own work record. Reducing the spousal benefit has been proposed in combination with improving benefits for widowed spouses and/or for providing credit for caring for young children as part of the benefit that workers earn based

on their own work records. The Congressional Budget Office (2009) includes this type of option in its deficit reduction options. One such option would gradually lower the supplemental spouse benefit for persons newly eligible in 2010 and later. The reduction from 50 to 33 percent of the primary worker's benefit would phase in by 1 percentage point a year over 17 years – from 49 percent for new eligibles in 2010, to 33 percent for new eligibles in 2026 and later. The change is estimated to lower the 75-year average costs by 0.12 percent of taxable payroll.

Conclusion

The purpose of this report is to stimulate public discussion about how policymakers could improve the adequacy of Social Security benefits as part of legislative reforms that bring Social Security's finances into balance over the next 75 years. We are not recommending any particular option or package of reforms. Box 1 illustrates one package as an example. Many options are possible beyond those described here, and many variations on these options could be designed. In brief, there are many ways to eliminate the current 75-year deficit in Social Security finances and there are many ways to improve the adequacy of Social Security benefits and pay for those improvements. Fixing Social Security to improve benefit adequacy and balance long-term finances is a manageable challenge.

Table 1. Options to Increase Benefits for Adequacy

Cost as a percent of taxable payroll and as a share of the 75-year average deficit
2009 Baseline: Deficit of 2.00 percent of taxable payroll

Option	Description	Cost as Percent of Taxable Payroll	Percentage Increase in Shortfall
	Increase Benefits at Age 85		
1a	5% benefit increase at age 85	0.09	4
1b	Uniform dollar increase at age 85 (5% average)	0.09	4
	Pay Widowed Spouse 75% Benefit[a]		
2a	With cap at "average earner" benefit	0.06	3
2b	With cap at "maximum earner" benefit	0.30	15
	Credit for Childcare		
3	Up to five years of childcare credits at half the average wage while a child is under 6	0.24	12
	Special Minimum for 30 Years' Work		
4a	125% of poverty at full benefit age for 30 year worker, wage indexed formula	0.13	7
4b	4a plus up to 8 years of coverage based on credit for a child under age 5	0.26	13
	Student Benefits		
5	Reinstate student benefits until age 22 for children of disabled or deceased workers	0.07	4
	Across the Board Increases		
6a	20% benefit increase	2.98	149
6b	5% benefit increase	0.75	37
6c	2% benefit increase	0.30	15

[a] These are preliminary estimates and may change with more refined analysis.
Source: Cost estimates provided by the Social Security Administration, Office of the Chief Actuary.

Table 2. Options to Increase Trust Fund Income for Solvency

Income as a percent of taxable payroll and as a share of the 75-year average deficit
2009 Baseline: Deficit of 2.00 percent of taxable payroll

Option	Description[a]	Income as Percent of Taxable Payroll	Percentage Decrease in Shortfall
	Social Security Contribution Rate Increase		
7a	Raise from 6.2% to 7.3% in 2010	2.09	104
7b	Raise to 7.2% in 2022 and to 8.2% in 2052	2.06	103
7c	Raise by 1/20 of 1% a year, 2015-2034	1.39	69
	Raise the Tax Cap		
8a	End the cap; don't count the earnings	2.32	116
8b	End the cap; count earnings toward benefits	1.89	95
8c	End the cap; count earnings with a flatter formula	2.17	108
8d	Gradually restore the cap to 90% of earnings	0.57	28
8e	End cap for employers; gradually restore cap to 90% of earnings for employees[b]	1.43	72
	Extend Coverage		
9	Cover newly hired state and local employees	0.17	9
10	Treat salary reduction plans like 401(k)s[b]	0.25	12
	Use Progressive Taxes for Legacy Costs		
11a	Dedicate the estate tax to Social Security[c]	0.51	26
11b	Same as above, but assume the threshold is indexed[b]	0.40	20
12	3% tax on earnings above the tax cap	0.57	28
13a	3% tax on adjusted gross income (AGI) over $250,000 for couples and $125,000 for individuals[b]	0.74	37
13b	5% legacy tax on AGI over $250,000 for couples and $125,000 for individuals[b]	1.23	62
	Maintain Reserves and Diversify Investments		
14a	Gradually invest 15% of funds in equities		
	Assume 6.4% return over inflation	0.27	14
14b	Gradually invest 40% of fund assets in equities		
	Assume 6.4% real return	0.67	33
	Assume 5.4% real return	0.48	24
	Assume 2.9% real return	0.00	0

[a] All estimates based on the 2009 Social Security Trustees Report unless otherwise indicated.
[b] These are preliminary estimates and may change with more refined analysis.
[c] Estimate based on 2004 Social Security Trustees Report.
Source: Estimates provided by the Social Security Administration, Office of the Chief Actuary.

Table 3. Options to Reduce Benefits for Solvency

Cost reduction as a percent of taxable payroll and as a share of the 75-year average deficit
2009 Baseline: Deficit of 2.00 percent of taxable payroll

Option	Description[a]	Savings as Percent of Taxable Payroll	Percentage Decrease in Shortfall
	Reduce Cost-of-Living Adjustment		
15a	Lower COLA by 1% each year	1.55	78
15b	Lower COLA by ½% each year	0.81	40
15c	Adopt the "chained" CPI developed by BLS	0.49	24
	Raise the Age for Full Retirement Benefits[b]		
16a	Speed up rise to 67; then up 1 mo. every 2 yrs. to 68	0.46	23
16b	Speed up rise to 67; then up 1 mo. every 2 yrs. to 70	0.62	31
16c	Gradually index the age for longevity indefinitely	0.37	18
	Lengthen Career-Earnings Averaging Period		
17a	Increase from 35 to 38 years (but not for disability)	0.29	14
17b	Increase from 35 to 40 years (but not for disability)	0.46	23
	Reduce Benefits for New Beneficiaries		
18a	3% cut in 2010	0.36	18
18b	5% cut in 2010	0.61	30
19	Price-index benefits for successive generations starting in 2013	1.31	65
20	Lower Spouse Benefits	0.12	6

[a] All estimates based on the 2009 Social Security Trustees Report unless otherwise indicated.

[b] Estimates based on 2008 Social Security Trustees Report.

Source: Estimates provided by the Social Security Administration, Office of the Chief Actuary.

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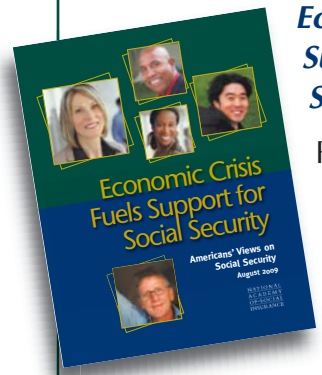

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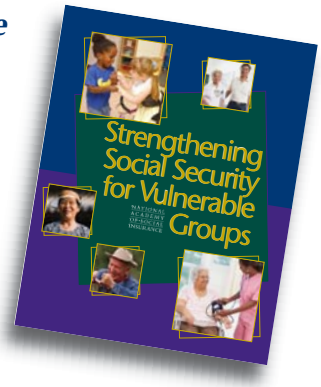

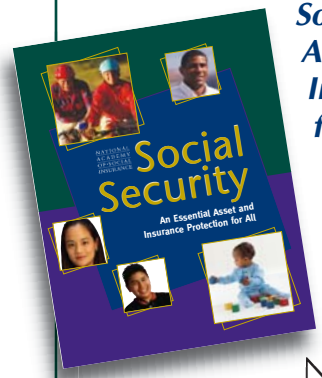

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