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Social Security Basics

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What Is Social Security?

Social Security is the most popular government program. However, most people know little or nothing about how it operates. The following discussion explains what Social Security is, how it operates, and why there is such an intense debate about its future.

The Programs That Make Up Social Security

Social Security is made up of three major programs that are administered by the Social Security Administration:

1. *Retirement:* This program provides a lifetime monthly income for qualified workers once they have reached their full retirement age. Depending on when they were born, that age ranges from 65 to 67. The amount of retirement benefits they get depends on their income while they were working. Workers also have the option of instead receiving a lower monthly income starting at age 62.
2. *Survivors:* This program provides a monthly lifetime income to the surviving spouse of a deceased worker once he or she reaches retirement age. The amount that he or she receives depends on both spouses income while they were working. The survivors program also pays benefits to children under the age of 18 and a surviving spouse caring for them. These benefits end in most cases when the surviving children reach age 18.
3. *Disability:* Social Security also pays lifetime monthly income to workers who are disabled and in some cases to their spouses and children under the age of 18. These benefits depend on the worker's earning history.

Qualifying for Social Security

Workers do not automatically qualify for Social Security retirement benefits. Instead, they must have worked and paid at least a minimum level of Social Security taxes for at least 40 quarters. These quarters do not have to be consecutive. Currently, workers earn one quarter of credit in each three-month period when they earn at least $870. Once they have worked and paid Social Security taxes for the required 40 quarters, workers are fully qualified to receive Social Security retirement benefits. They are also qualified to receive disability benefits and to have survivors benefits paid to their children under the age of 18 and their spouses if they have paid Social Security taxes for a certain number of quarters in the recent past.

Disability benefits are paid to workers who have been disabled for at least one year. In order to qualify, a worker must have paid Social Security taxes within the recent past. Disabled in this case means unable to perform any substantial gainful work due to severe physical or mental impairment. Determination of eligibility is based on medical evidence and made by a government agency in the state in which the worker lives.

There is no requirement that an individual must be an American citizen to qualify for Social Security. While employers are required by other laws to ensure that anyone they hire is either a citizen or a legal immigrant, foreign nationals can earn Social Security credits with a valid Social Security number.

What About SSI?

The Supplemental Security Income (SSI) program is not part of Social Security. SSI helps aged, blind, and disabled people who have little or no income. It provides cash to meet basic needs for food, clothing, and shelter. To get SSI, a worker must be 65 or older or blind or disabled. Even though the Social Security Administration administers SSI, the program is paid for with general tax revenues. No Social Security payroll taxes go to pay for SSI.

What About Medicare?

Medicare is a federal program that helps to pay for older Americans health costs. Some people incorrectly consider Medicare to be part of the Social Security system because taxes that finance part of Medicare are lumped in with those that pay for Social Security. However, Medicare is also financed by premiums and general revenue, and is not administered by the Social Security Administration. For that reason, Medicare is not considered to be part of Social Security for the purposes of this paper.

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What Is FICA?

The taxes that pay for Social Security's programs are confusing to most people. On most workers' paychecks, they are hidden under the term "FICA," and even the amount under FICA accounts for only half the taxes paid on their behalf. Below is a discussion of how Social Security is financed.

Payroll Taxes and Amounts

Unlike most other government programs, Social Security (and Medicare) are paid for through explicit taxes that are not supposed to be used for any other purpose. These taxes are based on a worker's earned income and deducted from his or her paychecks. For that reason, Social Security taxes are often referred to as "payroll taxes." Payroll taxes are in addition to any income taxes that the worker must pay.

For all intents, there are separate payroll taxes that finance Social Security's retirement and survivors benefit program, Social Security's disability benefit program, and Medicare. As seen below, the three are often lumped together on a worker's pay stub. The two Social Security taxes are only paid on income up to a certain annual amount. Medicare taxes are collected on all earned income.

In 2002, workers and employers pay total payroll taxes equal to 15.3 percent of the first $84,900 in income and 2.9 percent of income above that amount. The $84,900 dividing line is call the "earnings cap" and is discussed below. Of that 15.3 percent total, payroll taxes equal to 10.6 percent of income go to pay for Social Security's retirement and survivors program, and 1.8 percent goes to pay for Social Security's disability program. These taxes are only collected on the first $84,900 that a worker earns each year. Medicare taxes equal 2.9 percent of income and are collected on all of a worker's earning income.

Payroll taxes are divided equally between a worker and his or her employer. The self-employed pay both portions. These issues are more fully discussed below.

FICA Defined

Most employers do not show the amount the worker pays for Social Security and Medicare on his or her paycheck stub. Instead, these taxes are lumped together and shown as a deduction for "FICA." FICA stands for the Federal Insurance Contributions Act. It is the part of the Internal Revenue Code that gives the federal government the ability to collect the payroll taxes that pay for both Social Security's programs and Medicare. The name refers to the idea that the amount collected to pay for these programs are actually contributions to a social insurance system. However, in reality, they are nothing more than taxes and it would be more honest to simply refer to them as such. As explained below, only half of the amount that is paid on behalf or by a worker appears on his or her paycheck. The other half of the FICA taxes is paid by the employer and is not usually disclosed to the worker.

All Deductions Matched by Employer

Only half of the taxes that a worker pays for Social Security can be found on his or her paycheck. Employers pay an equal amount of payroll taxes on his or her behalf. As far as the employer is concerned, these additional taxes are part of the worker's pay. Even though the worker does not see this income, the employer actually pays $10,765 for each $10,000 the worker earns. If that worker were not employed, the employer would not have to pay those taxes.

If this added money was not paid to the government as payroll taxes, it could go to the worker as income. For this reason, both halves of the FICA tax must be counted as being paid by the worker. Instead of paying taxes equal to 5.3 percent of income for retirement and survivors benefits, the worker is actually paying 10.6 percent of income. The combined total is the true cost to each worker.

Self-Employed Workers

The self-employed must pay both the employer and the employee halves of payroll taxes. Combining the payroll taxes for Social Security's retirement and survivors program, Social Security's disability program, and Medicare, the self-

employed pay a total of 15.3 percent of income below $84,900 in 2002 and 2.9 percent of income above that. These payroll taxes are in addition to any income taxes that are owed.

Retirement and Survivors Tax Amount

The largest amount of payroll taxes collected under FICA goes to pay for a worker's retirement and survivors benefits. The taxes pay for both monthly income to the worker at retirement and monthly checks after the worker's death that are paid to a spouse and any children under the age of 18. The worker and his or her employer pay a total of 10.6 percent of income up to the earnings limit for these programs. The amount is evenly split between the two, with each paying an amount equal to 5.3 percent of the worker's income. These taxes go into the Old-Age and Survivors Insurance (OASI) trust fund. (See Part IV for a discussion of the trust funds.)

Disability Tax Amount

Workers pay 1.8 percent of income (up to the earnings limit) for disability benefits. These taxes go into the Disability Insurance (DI) sub-trust fund (see Part IV for a discussion of trust funds) and are used to pay monthly benefits to workers who are unable to work due to a long term physical or mental disability. As with all payroll taxes, half the amount (equal to 0.9 percent of income) is deducted from the worker's pay, and the employer pays the other half in his or her behalf.

Earnings Limit, Why It Is There, and How It Is Increased

In 2002, Social Security taxes are only collected on the first $84,900 that a worker earns. This figure is known as the "earning limit" and it changes each year. Social Security benefits are only paid on the amount of income that is taxed to pay for it. Thus, in Social Security's eyes, both Michael Jordan and Bill Gates earn $84,900 a year regardless of their actual income.

The earnings limit keeps Social Security from having to pay benefits on Bill Gates' entire income. It allows the program to say that it covers all Americans without paying the very rich benefits that are much higher than those that go to average income workers. Every October, the Social Security calculates and announces the earnings limit for the following calendar year. The change in the earnings limit is based on the increase in both the cost of living and the average income.

Income Taxes on Some Social Security Benefits

Since 1983, retirees who have total annual incomes above a certain amount must pay income taxes on a portion of their Social Security benefits. The money raised through this taxation goes back to Social Security. Retirees who file as an individual may have to pay income taxes on up to 50 percent of their benefits if their total income is between $25,000 and $34,000. If their total income is above $34,000, they may have to pay income taxes on up to 85 percent of their benefits. Married retirees may have to pay income taxes on up to 50 percent of their benefits if their total annual income is between $32,000 and $44,000, and on up to 85 percent of their benefits if they earn over $44,000. Income taxes on Social Security benefits are paid at the same rates as are paid on other types of earned income.

Until 1983, all Social Security benefits were income tax free. The real reason that Congress began this taxation was that Social Security needed additional revenue at the time. However, it was justified because the half of payroll taxes paid by employers can also be deducted from the employer's corporate income taxes, while workers must pay income taxes on the amount of their check that is deducted as payroll taxes. Congress decided that since companies received a tax deduction on the amount of payroll taxes they pay on behalf of workers, Congress could recapture that tax benefit by assessing income taxes on half of some retirees' benefits.

What Are the Trust Funds?

People tend to think of their Social Security benefits as an actual account, in their name, which contains cash or investments. In reality, the Social Security trust fund contains nothing more than IOUs that have no value beyond a promise to impose higher taxes on future workers. The annual surpluses that many thought were being used to build up a reserve for baby boomers have

been spent on other government programs or to reduce the government debt.

The Social Security Trust Funds

Social Security has two trust funds, one for its retirement and survivors program, and one for its disability insurance. The formal name of the retirement and survivors trust fund is the Old-Age and Survivors Insurance trust fund, and it is often referred to as the OASI trust fund. The Disability Insurance trust fund is referred to as the DI trust fund.

These two trust funds are linked, and are often referred to as one. In that case, the combined entity is referred to the Old-Age, Survivors and Disability Insurance trust fund, or OASDI. Despite the fact that there are two trust funds, most of the time estimates of Social Security's finances use the combined OASDI trust fund. It is extremely important to check which trust fund measure is being used. For instance, according to the 2001 trustees report (see below), OASDI will begin to spend more than it takes in by 2017, but the OASI trust fund alone will not begin to spend more than its tax revenues until 2018. The difference is due to DI's poor financial state. The DI trust fund will begin to spend more than it takes in from taxes starting in 2009.

In addition to the two Social Security trust funds, there is also a Health Insurance (HI) trust fund that helps to fund part of Medicare. The HI trust fund is managed and invested in the same way as the OASI and DI trust funds. Because this course only deals with Social Security, the HI trust fund is not discussed.

The Trustees and Their Annual Report

The same trustees manage the OASI and DI trust funds. They also manage the HI trust fund. Three of the six trustees are cabinet officials, the Secretaries of the Treasury, Labor and Health and Human Services. The Secretary of the Treasury serves as Managing Trustee. In addition, the Commissioner of Social Security is a trustee, and two public trustees are appointed by the president and confirmed by the Senate for four-year terms. John L. Palmer and Thomas R. Saving will serve as public trustees until October 2004.

Every year, the trustees are required to issue a report that details both the financial activities in the trust funds and the long and short-term outlooks for Social Security's programs. Available from SSA both on-line and in published copies, these annual reports are a wealth of numbers, statistics and predictions. In addition to the numbers from the most recent year, the reports predict Social Security's financial status for both the next 10 years and for the next 75 years. The report includes predictions based on the most likely economic scenario as well as both more optimistic and more pessimistic outcomes.

Often press reports focus on the simplest statistics, such as the year in which the trust funds are predicted to run out of assets. However, a more careful examination reveals other important information such as the total unfunded liability of the system and the year in which the programs must begin to spend more than they take in. These are actually more important to determining the programs' ability to meet the needs of those who depend upon them.

OASI – The Retirement and Survivors Trust Fund

By far the larger of the two Social Security trust funds, the Old-Age and Survivors Insurance (OASI) trust fund pays retirement and survivors benefits. In calendar year 2001, the OASI trust fund had a total income of $518.1 billion. Of that total, $441.5 billion (85.2 percent) came from payroll taxes, $11.9 billion (2.3 percent) came from income taxes paid on higher income retirees' Social Security benefits, and $64.7 billion (12.5 percent) was interest paid on special issue Treasury bonds contained in the trust fund.

During that year, the trust fund paid out $375.6 billion in benefits (72.5 percent of the taxes it collected) and $2.0 billion (0.4 percent) for administrative expenses. The remaining $140.6 billion (27 percent) was retained in the trust fund. As a result, the trust fund's assets grew from $931 billion at the beginning of the year to $1.072 trillion at the end of 2001.

DI – The Disability Trust Fund

The smaller of the two Social Security trust funds, the Disability Insurance (DI) trust fund pays disability benefits. In calendar year 2000, the DI trust fund had a total income of $83.9 billion. Of that total, $74.9 billion (89.3 percent) came from pay-

roll taxes, $0.8 billion (1.0 percent) came from income taxes paid on higher income workers' disability benefits, and $8.2 billion (9.7 percent) was interest paid on special issue Treasury bonds contained in the trust fund.

During that year, the trust fund paid out $59.6 billion (71.4 percent of taxes collected) in benefits and $1.7 billion (2.0 percent) for administrative expenses. The remaining $21.1 billion (26.6 percent) was retained in the trust fund. As a result, the trust fund's assets grew from $118.5 billion at the beginning of the year to $141 billion at the end of 2001.

How Social Security Trust Funds Differ from Real Trust Funds

Private sector trust funds invest in real assets ranging from stocks and bonds to mortgages and other financial instruments. Assets are held only for a specific purpose, and the fund managers are liable if the money is mismanaged. Funds are managed in order to maximize earning within a pre-agreed risk level. Investments are chosen that will provide cash at set intervals so that the trust fund can pay its obligations.

The Social Security trust funds are very different. In the words of the Office of Management and Budget (OMB):

> The Federal budget meaning of the term “trust” differs significantly from the private sector usage.... The Federal Government owns the assets and earnings of most Federal trust funds, and it can unilaterally raise or lower future trust fund collections and payments, or change the purpose for which the collections are used. (Analytical Perspectives, Budget of the United States Government, Fiscal Year 2000 (Washington, D.C.: U.S. Government Printing Office, 1999), p. 335.)

Even more important, the Social Security trust funds are only “invested” in a special type of Treasury bond that can only be issued to and redeemed by the Social Security Administration. As the Congressional Research Service noted:

> When the government issues a bond to one of its own accounts, it hasn't purchased anything or established a claim against another entity or person. It is simply creating a form of IOU from one of its accounts to another. (David Koitz, “Social Security and the Federal Budget: What Does Social Security's Being Off-Budget Mean?” Congressional Research Service, May 5, 1998.)

As a result:

> These [Trust Fund] balances are available to finance future benefit payments and other trust fund expenditures—but only in a bookkeeping sense. These funds are not set up to be pension funds, like the funds of private pension plans. They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury, that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large trust fund balances, therefore, does not, by itself, make it easier for the government to pay benefits. [Italics added] (Analytical Perspectives, Budget of the United States Government, Fiscal Year 2000 (Washington, D.C.: U.S. Government Printing Office, 1999), p. 337.)

In short, the Social Security trust funds are really only an accounting mechanism. They show how much the government has borrowed from Social Security (see below for details), but do not provide any way to finance future benefits.

How Money Goes To and From the Trust Fund

When an employer pays taxes to the Treasury, he or she sends in one periodic check that includes both income taxes and payroll taxes. (See Section II for a discussion of Social Security taxes.) All that is sent is a check or electronic transfer; there is no indication of how mush of the check is payroll taxes and how much is income taxes. There is also no indication of which employees' taxes are being paid or how much they earn.

On a regular basis, Treasury estimates how much of its aggregate tax collections are due to Social Security taxes and credits the trust funds with that amount of money. No money changes hands; this crediting is strictly an accounting transaction. These

estimates are corrected after income tax returns show how much payroll taxes were actually paid in a specific year. In addition, Treasury credits the trust funds with interest paid on its balances and with the amount of income taxes that higher income workers pay on their Social Security benefits.

Social Security directs Treasury to pay monthly benefits, and that amount is subtracted from the total in the trust funds. Any remainder is converted into special issue Treasury bonds, which are really nothing more than IOUs. (See above for details on why.)

After the trust fund has been credited with the IOU, Social Security's extra tax collections are then spent just like any other taxes. In recent years, that amount was used to repay federal debt owned by the public, but if necessary, it could also be spent to pay for any other type of federal program from aircraft carriers to education research.

Special Securities Issued to Trust Funds

The Social Security trust fund consists totally of special issue Treasury bonds and certificates of indebtedness. They are special in that these bonds can only be issued to and redeemed by the Social Security trust funds. These bonds cannot be sold in the open market.

The Social Security trust fund bonds pay the same interest as regular Treasury bonds issued on the same day and in the same maturity. When the bonds mature, they are rolled over into new bonds that include both the original issue amount and any interest due. The new bonds pay whatever interest as regular Treasury bonds of the same maturity issued on that date.

As mentioned above, these bonds are really nothing more than IOUs from one branch of government to another. They are not a real financial asset.

Until relatively recently, these bonds only existed as entries in a record book. However, now when a new bond is issued, it is printed on a laser printer located at the Bureau of the Public Debt's Martinsburg, WV office. The bond is then carried across the room and put in a fireproof filing cabinet. That filing cabinet is the Social Security trust fund.

How Trust Fund IOUs Would Be Repaid

At some point in the future, Social Security will need to spend more than it receives in payroll taxes. At that point, it will begin to cash in the bonds in the trust fund. Where will the money come from?

According to the OMB, there are only four sources that money can be drawn from. Congress could repay the money by raising other taxes. It could also authorize the Treasury to just borrow the needed funds. Another alternative would be for Congress to reduce other federal programs and to use the money that was to have been spent for them to redeem Social Security bonds. Finally, Congress could simply reduce Social Security benefits. None of these options is either easy or very attractive.

How Are Social Security Benefits Determined?

Social Security benefits are based on earnings averaged over most of a worker's lifetime. Most people know about Social Security's retirement benefits, but the program also pays benefits to disabled workers. In addition, families can receive benefits under certain circumstances. The formula that the agency uses to determine the amount of benefits a worker or his or her family receives is quite complex. And to complicate matters even more, there are a number of special circumstances that can alter those benefits.

What follows is a general analysis suitable for policy makers. For individual cases, it may be wise to seek guidance from either SSA or other sources.

When Can a Worker Retire?

There are actually two answers to this question. A worker can begin to collect Social Security benefits as early as age 62, but cannot begin to receive full retirement benefits until between 65 and 67. The exact age for full benefits depends on date of birth. Workers born before 1938 can receive full retirement benefits starting at age 65. The full retirement age climbs by two months per year for workers born between 1938 and 1942, and is 66 for those born between 1943 and 1954. The full benefits age then climbs by two months per year

for those born between 1955 and 1959, and will be 67 for anyone born in 1960 or after.

If a worker decides to receive benefits starting when he or she is 62, then monthly benefits will be reduced by a set percentage for each month that the worker begins to receive benefits before his or her full retirement age. As the full retirement age climbs from 65 to 67, workers who retire early will receive an even greater reduction in their monthly benefits. Currently, if a worker retires at 62, he or she receives 80 percent of the full retirement age amount. This will eventually drop to 70 percent if a person's full retirement age is 67.

Benefits also increase for every month that a worker begins to receive retirement benefits after he or she reaches full retirement benefits age. This growth continues until age 70.

Qualifying for Retirement Benefits

Everyone is not qualified to receive Social Security benefits. In order to qualify, one has to earn at least 40 quarterly credits. Workers receive one credit by earning at least $870 in a three-month period and paying Social Security taxes on that amount. Workers who earn $3,480 during a year receive 4 credits. The amount of income required to earn a credit changes annually, but this does not affect credits that have already been earned. Once a worker has earned the required 40 credits, he or she is permanently qualified. However, the level of benefits that a worker actually receives depends on his or her income history.

There are similar requirements for the Disability Insurance program, but the number of credits necessary to qualify varies depending on the age at which one becomes disabled.

The General Formula for Retirement Benefits

Retirement benefits are based on a worker's highest 35 years earnings. Those wages are indexed so that all 35 are have the same purchasing power of the most recent year, and are then divided to get the worker's average monthly salary. This is known as the Average Indexed Monthly Earnings (AIME). The AIME is run through a formula that calculates benefits equal to 90 percent of AIME up to a certain level of monthly income, 32 percent of AIME from that level to a higher point, and 15 percent of AIME from that point on. The differing payment levels are known as “bend points.” The three payment levels are added up to find the worker's monthly Social Security retirement benefit.

As an example, in 2002, if a worker's AIME was equal to $4,000, he or she would receive about 90 percent of the first $590 ($531), 32 percent of the amount between $590 and $3,567 ($953), and 15 percent of the amount between $3,567 and $4,000 ($65). Thus the monthly Social Security benefit would be $1,549. The actual numbers of the bend points change each year. For more detail, see below.

Determining Average Indexed Monthly Earnings (AIME)

Retirement benefits are calculated using a worker's highest 35 years earnings. If the worker has an earnings record of more than 35 years, years with the lowest earnings are dropped. Only those earnings that the worker paid Social Security taxes on are counted. Thus, if the worker earned $100,000 in 2001, that year's income would be counted as $80,400 for determining benefits, since the worker only paid Social Security taxes on that lower amount.

Earnings for previous years are indexed so that all years are measured by the same ability to purchase goods and services. This indexing increases past earnings to account for both inflation and increases in average wage growth. (See below for how past earnings are indexed.) For instance, if it would take $11.48 in 2002 dollars to equal $1.00 earned in 1951, and $1.53 to equal $1.00 earned in 1990.

Once all 35 years' earnings records are indexed to the same standard, they are added together and divided by 420 (the number of months in 35 years). The result is the Average Indexed Monthly Earnings (AIME), and is used to calculate Social Security benefits.

Some jobs, usually for state or local governments, are not covered by Social Security, and earnings for those jobs are not included in determining AIME. Also, if the worker has not been in the labor force for 35 years, perhaps due to raising a family or because of illness, then zeros are included for any years that are missing. In practice, this means that if a worker has only 25 years in a job covered by

Social Security, regardless of the reason, then the indexed earnings from those 25 years are added together and divided by 420. This lowers AIME to account for the missing years. There are other adjustments to Social Security benefits earned by state and local government workers. See both “government pension offset” and “windfall elimination provision” below.

Wage Indexing vs. Price Indexing

In creating AIME, a worker’s past wages are indexed to bring them to the same level as today’s earnings. However, there are two possible ways that these past earnings could be indexed.

Price indexing is based upon the Consumer Price Index (CPI), and eliminates the effects of inflation. The result is to bring all wage amounts to a constant purchasing power. In this case, if inflation had increased by 5 percent since last year, simply multiplying last year’s wages by 1.05 would result in the amount necessary to be able to buy the same amount of goods as last year.

Wage indexing is based on the growth in average wages, and is supposed to allow workers to have roughly the same standard of living. The growth in average wages includes both inflation and growth in the overall economy. Under most circumstances, wage indexing should result in a higher AIME than price indexing. Social Security uses wage indexing only when calculating AIME. Once an initial monthly benefit has been determined, it is price indexed from then on to protect retirees from inflation.

The difference between the two forms of indexing can be very important. If a worker had been a bricklayer throughout his or her career, and earned $4.00 an hour in 1980, indexing that amount for inflation (an increase of 86.9 percent) would result in an indexed wage of $7.48 an hour. On the other hand, indexing that $4.00 an hour in 1980 for average growth in wages (an increase of 157 percent) would result in $10.28 an hour. While it is true that $7.48 in 2002 would buy the same amount as $4.00 in 1980 would, it may well be that the average wage for a bricklayer in 2002 has increased to something closer the $10.28 an hour figure.

Wage indexing allows retirees to take advantage of the increase in the standard of living over their working careers. However, it is often criticized as giving workers a retroactive credit for improvements in the economy. In other words, his or her 1980 wages are being measured according to the economy of 2002, rather than being a measure of the 1980 economy when they were actually earned. The key difference is in the consideration of replacement rates (see below under section VII).

Using Bend Points to Come up with a Benefit Amount

Once an AIME has been calculated, SSA calculates a worker’s monthly retirement benefit using a formula that pays a higher benefit relative to income to lower income workers than it does to those who have earned more. In 2002, Social Security will pay an amount equal to 90 percent of the first $592 of a worker’s AIME. Then, it pays 32 percent of the AIME amount over $592 through $3,567, and 15 percent of any AIME amount over $3,567. The income divisions in this formula are called “bend points. ”Bend points are adjusted each year.

To repeat the example above, if a worker had an AIME equal to $4,000, he or she would receive about 90 percent of first $590 ($531), 32 percent of the amount between $590 and $3,567 ($953), and 15 percent of the amount between $3,567 and $4,000 ($65). Thus the monthly benefit would be $1,549, or about 39 percent of his or her AIME. On the other hand, if the worker’s AIME had been only $1,200, he or she would have received 90 percent of the first $590 ($531) and 32 percent of the amount between $590 and $1,200 ($195) for a total monthly benefit of $726. However, this amount would be equal to 61 percent of AIME.

Annual COLA Increases

Monthly benefits are increased by the every year by the amount of inflation. This is known as the Cost of Living Adjustment (COLA), and it is intended to preserve the purchasing power of a recipient’s benefits. The amount of the annual increase is announced each October although the change does not take effect until January 1 of the following year. It is based on the change from the third quarter in the year before the announcement is made through the third quarter in the year of the announcement. SSA currently uses the Department of Labor’s Con-

sumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) to measure inflation, but under some circumstances, it could use the annual increase in average wages instead.

As an example, on October 19, 2001, SSA announced a COLA increase of 2.6 percent for all checks issued after January 1, 2002. The increase was based on the change in CPI-W from the third quarter of 2000 through the third quarter of 2001.

The Retirement Earnings Limit: Working while Receiving Retirement Benefits

Until a couple years ago, any worker under the age of 70 who received Social Security retirement benefits and chose to return to work would lose a substantial portion of his or her Social Security benefits. However, Congress has eliminated this penalty for workers who have reached their full retirement age. Workers between the age of 62 and full retirement age do face the likelihood of losing most of their benefits if they continue to work.

In 2002, workers under full retirement age can earn up to $11,280 without any consequences. However, for every two dollars they earn over that amount, their Social Security benefits will be reduced by one dollar. Rather than just reducing each month's benefits equally, Social Security simply does not pay any benefits at all until the amount of the reduction is reached. Thus if benefits were to be reduced by a total annual amount of $4,500 and the monthly benefit was $1,000 a month, the worker would receive no Social Security check at all for January through April and half a check ($500) for May. Starting in June, the worker would again receive $1,000 a month through December.

The Government Pension Offset: What It Is and How It Works

Government Pension Offset affects the spouses of workers who held jobs that were not covered by Social Security. Most of these workers were either state and local government employees or joined the federal government prior to 1984. Spouses of Social Security recipients also qualify for a benefit equal to 50 percent of the worker's benefit. However, the dual entitlement rule (see below) reduces that benefit dollar for dollar by any Social Security benefits that the spouse qualifies for under his or her own earnings record.

Since government workers who were not covered by Social Security do not have any of their own Social Security benefits, theoretically, they would qualify to receive the full spousal benefit. Thus, a person who joined the federal government prior to 1984 would be able to receive both his full Civil Service Retirement System (CSRS) pension and a Social Security spousal benefit equal. In order to eliminate this dual benefit, Congress created the Government Pension Offset in 1977.

Under this rule, two-thirds of the CSRS pension would be treated as though it were a Social Security benefit, and the spousal benefit that worker could receive is reduced dollar for dollar by that amount. Thus, if the CSRS worker had a $1200 a month pension, $800 of his or her CSRS pension (2/3) would be treated as coming from Social Security. If that worker's spouse also received $1200 a month from Social Security, that worker would also be eligible for a Social Security spousal benefit of $600 (half the spouses basic retirement benefit). However, it would be eliminated because the portion of the CSRS pension that is treated as coming from Social Security under Government Pension Offset is larger ($800) than the potential spousal benefit ($600).

As a result of the Government Pension Offset, the CSRS worker and his or her spouse have received the same treatment as if both of them were covered by Social Security. Government Pension Offset affects about 300,000 retirees, and reduces Social Security's aggregate benefits by approximately $1 billion annually. While a major proportion are retired federal workers, most of the rest were employed by state and local governments which chose not to participate in the Social Security program. The vast majority of these workers come from eight states: Alaska, California, Colorado, Louisiana, Maine, Massachusetts, Nevada and Ohio.

The Windfall Elimination Provision: What It Is and How It Works

The Windfall Elimination Provision is similar to Government Pension Offset, except that it applies to the worker's benefits instead of his or her spouse's benefits. It only applies to workers who

have *both* a Social Security retirement benefit *and* a pension from a job that was not covered under Social Security, usually from a state or local government. It also applies to federal workers who were covered by the old Civil Service Retirement System instead of today's Federal Employees Retirement System.

Under the Windfall Elimination Provision, the first bend point (see above) in the formula used to calculate a worker's monthly benefit is reduced from replacing 90 percent of the first $590 (in 2002) of Average Indexed Monthly Earnings (AIME – see above for a discussion of what this is) is reduced to replacing 40 percent of that amount. This in turn lowers the affected worker's monthly benefit. As an example, a worker with an AIME of $1200 would see his or her monthly benefit reduced from $726 to $431, while a worker with an AIME of $4,000 would receive $1,254 instead of $1,549.

There are exceptions to this provision depending on how long the worker was employed in a job covered by Social Security. The longer a worker was employed in a job covered by Social Security, the lower the benefit reduction. If the worker received "substantial" earnings for 30 years or more, there is no reduction in his or her Social Security benefit at all, while receiving that level of earnings between 21 and 29 years results in the 90 percent replacement bend point being reduced to between 45 percent and 85 percent.

The Windfall Elimination Provision adjusts the benefit formula to reflect the fact that the affected worker has in fact a much higher income than are reflected in his or her Social Security earnings. It was created because the basic Social Security benefit formula is designed to give lower income workers more for their Social Security taxes than higher income workers. As discussed above, the assumption was that lower income workers would be less likely to have income from a private pension or savings. If a government worker spent 30 years in a job not covered by Social Security, and only 12 years in one that is covered, his or her Social Security earnings record (AIME) would appear to be very low when compared to his or her actual average income including both jobs. This is because all of the non-Social Security covered income would be excluded. As a result, he or she would receive a low-income worker's Social Security benefit despite the fact that he or she most probably is a middle or even upper income worker.

The Dual Entitlement Rule

It has long been a principle of Social Security that a worker cannot qualify for full benefits under both his or her earnings record and that of a spouse. Accordingly, although a married worker theoretically qualifies for both retirement benefits from his or her own earnings record and a spousal benefit equal to 50 percent of the spouse's retirement benefit, this situation comes under the dual entitlement rule.

The dual entitlement rule reduces the spousal benefit dollar for dollar by the amount of the retirement benefits the worker qualifies for under his or her own earnings record. Thus, if two spouses each qualify for $1200 a month from their own earnings record, and a spousal benefit of $600 a month (1/2 the basic retirement benefit), they would still only receive a total benefit of $1200. The $600 spousal benefit is eliminated because it is less than their earned retirement benefit.

On the other hand, if one spouse received $1200 a month and the other $400 a month from Social Security, the lower earning spouse would also qualify for a $200 spousal benefit. In that case, the $600 spousal benefit from the higher earning spouse would be reduced by the lower earning spouse's benefit ($600-$400), leaving a $200 spousal benefit. The dual entitlement rule potentially affects 96 percent of the work force.

Notch Babies: How and Why It Happened

"Notch babies" are certain workers who were born between 1917 and 1921. Due to a technical error in a 1972 law, they receive slightly lower benefits than workers born before them, although they also receive slightly higher benefits than workers born after them receive. As a result, legislation has regularly been introduced in Congress that would either raise their benefits or provide them with a lump-sum payment. However, a 1994 commission found that although they do receive slightly lower benefits than workers born before them, notch babies receive a fair return for their taxes. As a result, no legislation concerning notch babies has been considered, and this situation is unlikely to change.

Notch babies get their name from a line graph showing average benefits by age of birth. Because those born between 1917 and 1921 tend to receive slightly lower benefits than those born before, the line has a slight notch for those years. The problem was caused in 1972, when benefits were first indexed for inflation. Unfortunately, Congress made a technical error in the law that resulted in workers receiving double adjustment for inflation. By the time that Congress corrected this error in 1977, some workers had already retired with higher benefits than they should have received, and rather than lowering their benefits, Congress decided to correct the problem only for those who had not yet retired. In addition, rather than just correcting the law to lower benefits to where they should have been, Congress phased in the change over a five-year period. The phase-in affected workers born in 1917 to 1921, and created the notch.

How Survivors Benefits Are Calculated

Survivors benefits depend on the earnings history of the worker who died. The same formula that calculates retirement benefits is also used for survivors benefits. They are usually calculated as a percentage of the benefit that a worker would have been eligible for at the time of his or her death. In general, they can be received by a spouse and by any children under the age of 18.

Surviving spouses at or near retirement age receive a benefit that is based on the worker's retirement benefit. If the worker began to receive benefits at his full retirement benefits age, the surviving spouse will receive an amount equal to 100 percent of the worker's benefits. This is also true if the worker died before beginning to receive Social Security. However, if the surviving spouse is also entitled to receive benefits, he or she will only receive the larger of the two amounts. The survivor will not receive both the worker's benefit and his or her own benefit.

Where the worker decided to begin to receive benefits before he or she reached full retirement ages, such as at age 62, the survivor will also receive a reduced monthly benefit. The exact amount depends on the survivor's age and the level of the worker's benefit. As of 2002, a surviving spouse could receive benefits as young as age 60, but in that case would only receive 71.5 percent of the worker's full retirement age benefit. This percentage will change every year as the retirement age increases.

In addition to the monthly benefit, surviving spouses receive a one-time $255 death benefit. This benefit is only payable to spouses or children eligible to receive benefits.

Another situation occurs if the worker dies leaving children under the age of 18. In that case, both the child and the surviving spouse are eligible to receive a benefit equal to 75 percent of the retirement benefit the worker was qualified to receive at the time of death. Both children and the spouse continue to receive this benefit until the last child reaches age 18. Benefits are also payable up to age 19 if the child is in high school at that date or age 22 if the child is disabled. The total amount that the family can receive is between 150 percent and 188 percent of the worker's full retirement benefit amount.

How Disability Benefits Are Calculated

Currently, disability benefits are calculated using the same formula that is used to calculate retirement benefits. However, a worker who is disabled before he or she has worked 35 years will have disability benefits that are calculated using a shorter work history, and will not be penalized for not having worked as long.

It is not easy to be approved for Social Security disability benefits. The agency's definition of disability is very strict, and often half of those workers who apply for benefits are turned down. Some of those workers who are rejected will be approved on appeal, but the process can be long and complicated.

To be eligible, a worker must be unable to do any kind of substantial work because of physical or mental disabilities, which are expected either to last at least 12 months, or to end in death. Just because a worker is unable to do the job he or she held before the disability does not automatically qualify them for disability benefits. Depending on their age, experience and education, they may be regarded as qualified to do other work, even if it is for a lower salary, and denied disability benefits. Family members may also be eligible to receive benefits because of a worker's disability.

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What (If Anything) Is Wrong With Social Security?

Americans have come to realize that Social Security faces serious financial problems that are only going to get worse. This public concern is well grounded. Studies and official reports confirm that Social Security is approaching a major financial crisis, and even if its revenue and expenditures were in long-term balance, the program is providing poorer and poorer retirement income security for the money Americans contribute. Younger workers are especially aware that Social Security will not be able to provide the benefits they have been promised when they retire. Below is a discussion of the two major problems facing Social Security.

How Social Security Helped Earlier Generations

When President Franklin Roosevelt launched Social Security during the Depression, he and Congress considered it to be only one element—although a crucial element—of a three-part system that would provide a secure retirement for Americans. Social Security was to be a modest social insurance program designed to make sure that all Americans could count on a good basic pension. In addition, Roosevelt expected that retired workers would rely also on personal savings and private pensions supplied by employers.

The results were very good. Poverty among senior citizens is much lower than it was in the past, and much of the credit goes to Social Security. Workers born before 1935 earned a very high rate of return on their payroll taxes. For instance, according to GAO, the difference between what a worker born in about 1920 paid in Social Security taxes and received in benefits was the same as if he or she had invested them in stocks – about 7 percent a year after inflation. Unfortunately, younger workers will not benefit from Social Security as their parents and grandparents did.

Social Security's Two Problems

While polls show that most workers have some idea of the financial problems facing Social Security that is only half of the picture. In addition, younger workers will receive much less for their taxes than older workers did. On top of that, Social Security taxes are now so high that they make it much harder for lower income workers to save money outside of the system.

- *Problem I – The impending financial crisis*

For a host of reasons—ranging from demographics to the way that the program was designed—Social Security faces a financial crisis. The gap between what Social Security has promised to pay and what it expects to collect is staggering—and growing. Once the baby-boom generation begins to retire, barely a decade from now, today's small surpluses will quickly become larger and larger deficits. In 2016, the Social Security trust funds are expected to start paying out more in annual benefits than the system collects in payroll and income taxes. The SSA says that once those deficits begin, they will continue to grow larger and never end. There are a number of reasons for this impending crisis:

- *Fewer workers per retiree:* In 1950, 16 workers supported each Social Security recipient. Now there are barely three workers per recipient, and by 2030 the ratio will fall to two per beneficiary.
- *People live longer:* In 1935, the average 65-year-old was expected to live about 12.6 more years. Today, people who reach age 65 are expected to live more than 17 additional years. And by 2040, they will be expected to live at least 19 more years.
- *More workers take early retirement:* The trend toward early retirement undermines Social Security. As recently as 1960, 77 percent of people in their early sixties remained in the workforce. Today, that number has dropped to 55 percent. Instead of continuing to pay into the system, early retirees become a burden on those who still work.

If Congress does nothing, annual cash flow deficits are predicted to begin in 2017. In inflation-adjusted 2001 dollars, the annual deficits are estimated to reach about $72 billion in 2020, $275 billion in 2030, $429 billion in 2050, and $719 billion in 2070. It appears that the annual deficits would continue and grow in size for as long as they could be projected.

The 75-year projection will continue to get worse because, with each passing year, a surplus year is lost on the front end and a deficit year is added on the back end. Over the period ending in 2077, Social Security's unfunded liability—the total amount that it has to pay over and above the amount that it will receive in future taxes—is about $25 trillion.

2017 or 2041?

Opponents of reform often claim that Social Security will not face any financing problems until 2041, when its trust fund runs out of assets. The alternative is 2017, when the program will begin to pay out more in benefits than the amount of taxes that it takes in. SSA estimates that it will take between $5.5 trillion in 2002 dollars to repay the trust fund.

As Section IV shows, the bonds in the trust fund can only be repaid through higher taxes, lowered benefits, reduced government spending on other programs, or borrowing. Once the trust fund has been repaid, the law requires Social Security to cut benefits by the same amount as its annual operating deficit. By waiting until 2041, taxpayers will have nothing to show for the $5.5 trillion that must be used to repay the trust fund. Facing a huge annual operating deficit, they will have few options other than reducing benefits or increasing taxes.

- *Problem II - rates of return*

In addition to Social Security's impending financial problems, the program faces another problem that will be much harder to solve. Social Security is an extremely poor investment when one compares the amount of retirement taxes a worker pays over a career to the amount of retirement benefits that the worker will receive. It is especially bad for younger workers. A worker could earn a much higher retirement income by investing his or her taxes in government bonds or a portfolio of investments such as stock index funds.

Comparing the total amount of Social Security retirement taxes paid over a working lifetime by a 30-year-old, two-earner couple who make average incomes (about $29,000 a year each) with the amount they will receive in benefits shows that they will earn the equivalent of only 1.23 percent (after inflation) a year. Over their lifetime, together they will pay a total of about $320,000 in Social Security retirement taxes (including both the employer and employee shares) and can expect to receive about $450,000 in total retirement benefits.

If this same couple had been allowed to invest the same amount they paid in Social Security retirement taxes in a conservative portfolio of 50 percent super-safe U.S. Treasury bonds and 50 percent stock index funds, they could expect to have $975,000 at the time they retired—$525,000 more than they would get from Social Security. This equals a rate of return of 5 percent a year, which is over four times higher than they would get from Social Security.

Rates of return are much worse for younger families. For instance, a married couple with two children and a single earner who was born in 1932 do fairly well, receiving 4.74 percent on their retirement taxes. However, the same type of family in which the earner was born in 1976 will receive less than 2.6 percent. Families with earners born after 1976 will receive even less.

Single males do especially badly. An average-earning single male born after 1966 can expect to receive a rate of return after inflation of less than one-half of 1 percent on the Social Security retirement taxes that he pays.

To make matters worse, if a worker dies before retirement, all of the Social Security taxes that he or she paid throughout the years will be lost unless the worker leaves either young children or a spouse who qualifies for lower benefits. All that this worker receives from the thousands of dollars that he or she paid over a lifetime of work is a single $255 death benefit.

African-Americans Are Especially Hurt by Low Rates of Return

Although Social Security is structured to pay higher benefits to workers with lower incomes, low-income African-American males may actually pay more in Social Security taxes than they will get in benefits, even under the most favorable assumptions. Again, the younger the worker is the lower the rate of return. For example:

- A single, low-income, African-American male born after 1959 loses money in Social Security.

For instance, a single African-American male in his mid-20s who earns about $13,000 a year would get only about 88 cents in retirement benefits for every dollar that he pays in taxes. This equals a lifetime loss of about $13,400. If he had been allowed to invest his Social Security retirement taxes in a portfolio of 50 percent government bonds and 50 percent stock equity funds, he would not only have not lost money, he would have accumulated over $145,000 more at the time he retired.

- A 21-year-old African-American single mother who makes about $20,000 per year (the current average income for African-American females) can expect to receive a rate of return from Social Security of only 1.2 percent. Even just investing the amount of Social Security retirement taxes that she and her employer pay in U.S. government bonds would earn her around 3 percent. This translates into $93,000 more for retirement than she would get from Social Security. On the other hand, investing her Social Security retirement taxes in a portfolio of 50 percent government bonds and 50 percent stock index funds would earn her almost $383,000 for retirement (before taxes)—$192,000 more than she would get from Social Security.

Because of their lower life expectancy, African-Americans are hit especially hard by the inability to include Social Security retirement taxes in their estates. Except in situations where the worker leaves young children or a spouse with lower benefits, this money permanently leaves the community and benefits others with longer life spans.

Workers Have No Legal Right to Social Security Benefits

According to the Supreme Court, workers actually neither own nor have a legal right to their Social Security benefits. In fact, the Court has even said that Congress can end Social Security benefits at any time. In 1960, the Supreme Court ruled in Flemming v. Nestor that Americans have no property right to their Social Security benefits. In his dissent, Justice Hugo Black observed that this decision "simply tell[s] the contributors to this insurance fund that despite their own and their employers' payments the Government, in paying the beneficiaries out of the fund, is merely giving them something for nothing, and can stop doing so when it pleases."

Today's Social Security Taxes Crowd Out Other Savings

Approximately 75 percent of American workers pay more in Social Security taxes than they do in income taxes. Over the past few decades, both the Social Security tax rate and the amount of income subject to the tax have increased dramatically. Specifically:

- Over the past 50 years, the Social Security payroll tax rate has climbed from 2 percent (one percent by the employee and one percent in his or her behalf by the employer) to 12.4 percent (6.2 percent by each). The retirement portion of Social Security accounts for 10.6 percent of the payroll taxes.
- As recently as 1971, the tax applied only to the first $7,800 of income. As of January 1, 2002, this tax is collected on all income up to $84,900.
- The combination of higher rates and greater amounts of income subject to the tax has caused the maximum Social Security payroll tax to climb from $60 in 1949 to more than $10,500 today.

As Social Security taxes have risen, Americans have had fewer dollars left over for other types of saving. The average family now spends as much for Social Security taxes as they do for housing, and nearly three times more than they do for annual health care expenses. Because of rising payroll taxes for retirement, more poor and middle-income workers do not have the after-tax funds needed for other savings.

Approaches to Reform

With the formidable problems (see above) facing the Social Security program, simply doing nothing is not an option. If Social Security is to be available to future generations, something must be done – and soon. With every passing year, the time when Social Security will run surpluses becomes shorter.

And, once the program begins to run deficits, SSA predicts that they will not end for as far in the future as they can forecast.

How Can Social Security Be Fixed?

There are only three ways to cure Social Security's problems. To do this correctly, the cure has to both resolve the program's financial problems and raise younger workers' rates of return. The simplest way to fix Social Security is to either raise taxes and/or reduce benefits. These measures take care of the coming financial crisis. Unfortunately, they also make rates or return even worse than they are today. Essentially, one is paying more, getting less, or both.

The only other alternative is to make payroll taxes work harder by allowing workers to invest all or a part of them in stocks or bonds through personal retirement accounts (PRAs). Since stocks and bonds give workers a much higher rate of return than the current form of Social Security can offer, PRAs can both improve retirement income and help to close the gap between what today's Social Security promises and what it will be able to pay. The exact result depends on the amount of payroll taxes diverted into PRAs and how it can be invested.

Promised Benefits vs. What Social Security Can Actually Pay

In order to fairly understand the impact of Social Security reform, its benefits should be compared to what today's Social Security can actually pay for under its current tax structure, and not just to what it promises to pay. While this is not a crucial distinction in the near term, it becomes extremely important in future years.

If nothing is done, today's Social Security has the revenues to pay 100 percent of promised benefits through 2017. It also has a mechanism to collect enough additional non-Social Security taxes to pay full benefits through 2041. (For a discussion of how this works, see trust funds under Section III.) After that date, Social Security will only have enough resources to pay about 75 percent of promised benefits. Therefore, any comparison of benefits paid after 2041 should use what Social Security can actually afford to pay instead of what the program promises.

Comparing benefits payable under Social Security reform with what Social Security promises would be valid only if the discussion also included what specific steps would be taken to make up the funding shortage, and how much they would cost.

Why We Can't Grow Our Way Out of Trouble

Some supporters of the current Social Security system assert that its problems can be solved by faster economic growth. Without much evidence, they claim that current economic projections are entirely too pessimistic and that the financial shortfall will disappear if the numbers are made more optimistic.

Robert Reich, former Secretary of Labor in the Clinton Administration, for example, has called the SSA economic projections "wildly pessimistic." Economist James K. Galbraith claims that if higher growth rates were substituted for the SSA's projected rates, "future deficits disappear without any cuts in benefits or increases in taxes."

Regrettably, claims that Social Security can be saved by faster economic growth are wrong. If anything, the projections underlying the Social Security Administration's forecasts are likely to be overly optimistic. And even if they are not, higher growth will have little impact on the system's solvency. By some measures, faster growth could even add to Social Security's problems.

If the inflation-adjusted growth rate of average wages over the next 75 years increases over the current forecast by 56 percent, then:

- The date when Social Security will begin to spend more each year in benefits than it receives in payroll taxes would be pushed back by a mere two years.
- Although economic growth would increase revenues, over the long run, benefits would grow even faster. This will cause the annual deficits to be substantially larger than they are currently predicted to be.

In short, critics of reform are mistaken if they think faster-than-predicted economic growth will help the Social Security system avoid its financial crisis. Without fundamental reform that allows workers to invest their own Social Security taxes,

deep benefit cuts or steep tax increases will be required, regardless of how rapidly wages grow.

Raising Payroll Taxes

One way to eliminate Social Security's impending financial problems would be to raise payroll taxes. The resulting extra revenue would allow the program to meet its obligations. However, while the increases could be as low as 3 percent of income through about 2020, as Social Security's annual deficits grew, so would the tax increases necessary to fill the funding hole. As a result, by 2060, Social Security taxes would have to climb by over 50% to 19 percent of income. This figure does not include either income taxes or any taxes necessary to fund Medicare.

Social Security taxes already drive marginal rates above 40 percent for many taxpayers. A taxpayer in the 28 percent federal income tax bracket, for example, typically pays 5 percent in state income taxes and 15.3 percent in Social Security and Medicare taxes. An increase in payroll taxes would especially affect the self-employed, who pay both the employer and employee share of those taxes. Recent research indicates that a 5 percent increase in marginal tax rates leads to a 10.4 percent decrease in the probability of investment by those sole proprietors and that marginal tax rates that are high and progressive strongly discourage entry into self-employment and business ownership.

Eliminating the Earnings Cap on Payroll Taxes

Another way to increase payroll taxes without affecting lower income workers would be to raise or eliminate the taxable wage cap. Currently, workers only pay Social Security taxes on the first $84,900 that they earn. This cap increases each year. Those who support this step claim that it will raise enough additional revenue to greatly reduce the program's coming financial crisis.

Based on SSA's own projections, however, eliminating the cap on wages subject to the OASI payroll tax would generate only enough revenue to delay the date of the system's insolvency by a few years. Moreover, by 2035, the OASI program would have enough revenue on hand to pay only 87 cents on every promised dollar in benefits.

The cost of this change would be substantial. Specifically, eliminating the cap on taxable wages would:

- Result in the largest tax increase in the history of the United States to raise $505 billion (in nominal dollars) over five years and almost $1.2 trillion over 10 years.
- Fail to save Social Security. The OASI insolvency date would be pushed back only seven years, from 2017 to 2024.
- Increase the top effective federal marginal tax rate on labor income to almost 52.5 percent, its highest level since the 1970s.
- Reduce the take-home pay of 10.4 million workers by an average of $4,907 in the first year alone after the cap is removed.
- Weaken the economy by reducing the number of job opportunities and savings; in fiscal year (FY) 2011, the decline in job opportunities would exceed 1.1 million, and the loss in personal savings (adjusted for inflation) would amount to $39.5 billion.

Requiring State and Local Workers to Join Social Security

One proposal to ease Social Security's financial problems is to require that all state and local workers come under the program. SSA says that the extra taxes paid by these workers would close about 10 percent of the gap between what Social Security has promised and what it can afford to pay. Opponents point out that when these workers begin to receive benefits, the program's deficits will grow, and claim that it is unfair to force workers who have decent pension coverage into one (Social Security) that would still face serious funding problems.

Approximately 10 million state and local government workers are currently not part of Social Security. This amounts to about 30 percent of the total number of state and local employees. Most of those not in Social Security are located in seven states (California, Colorado, Illinois, Louisiana, Massachusetts, Ohio, and Texas).

The Social Security Act of 1935 did not allow state and local government workers to be part of Social Security because of a constitutional concern

about whether the federal government had the right to tax state and local governments. In the 1950's state and local governments were allowed to join Social Security if they so chose. At any point, they were free to leave the system. However, this all changed in 1983. As part of the reform Congress passed that year, all state and local governments that were part of Social Security at that time were required to remain in the system. Coverage was further expanded in 1991, when Congress required that all state and local government employees who were not part of a public pension plan must be covered by Social Security.

Government Investment of the Trust Fund

Evidence at the state and local levels with public employee pension funds demonstrates that politicians and their appointees often are tempted to steer the government-controlled pot of money toward special interests, political allies, or corporate contributors. In addition, even well intentioned policymakers are not qualified to invest funds and manage money. Simply stated, they do not face the bottom-line pressures that force private businesses and investors to allocate resources wisely. Yet, poor investment decisions have serious consequences. Most important, workers would earn lower returns on their money, and even small differences in rates of return translate into less retirement income.

There are several broad concerns about such government-controlled investment proposals:

- *Partial nationalization of business:* Government-controlled investment would allow politicians direct involvement in the economy. Under a system of government-controlled investment, the government would be able to purchase a significant percentage of publicly traded companies. Once it had become a dominant shareholder, the government could use its power to influence corporate decisions.
- *Special-interest investments:* Government-controlled investment could allow politicians to steer funds toward well-connected interest groups or corporate contributors. Politicians frequently use the levers of power to counteract markets by steering resources in certain directions. These same levers of power could be used for more narrow political purposes as politicians provide favors or steer resources to constituents and allies. A large pot of government-controlled money—such as would exist under the Clinton plan or similar schemes—would create the opportunity to divert money for special interests. This is what has happened in many countries in the less-developed world.
- *Political correctness:* Government-controlled investment invites "politically correct" decisions at the expense of retirees because politicians could forgo sound investments in unpopular industries (such as tobacco) to steer money toward feel-good causes even if those causes may end up losing money. Private fund managers are legally required to pick a well-balanced portfolio designed to maximize long-term returns. Unfortunately, it is not clear that managers in a system of government-controlled investment would have the same incentives. Politicians routinely go after certain industries and/or companies, and withdrawing investment funds would be one way to show their displeasure.

Lowering Social Security Benefits

Another way to bring Social Security's financial position into balance would be to reduce Social Security benefits. Those opposed to reform often point out that even if no action is taken to save Social Security, the program will still be able to pay about 75 percent of promised benefits after the trust fund runs out in 2041. However, the average payment to newly retired workers in 2001 was only $878 a month. Reducing Social Security benefits to what the system can actually pay once the trust fund is exhausted would be the equivalent to lowering the 2001 benefits to only $659 monthly. Currently, Social Security provides 90 percent or more of their income to 31 percent of all workers over the age of 65. Reducing benefits across the board would be especially cruel to lower income workers who need this money the most.

Means Testing Social Security Benefits

Instead of reducing Social Security benefits across the board, another way to reduce the program's eventual deficits would be to target the benefits of

those who need it the least through means testing. While the benefits of lower income workers would not be affected, those who have other sources of retirement income or significant other assets would see their benefits reduced or eliminated. However, such a move would threaten the program's deep support and begin the process of moving it to a welfare program. Currently, all workers both pay Social Security taxes and receive benefits once they retire. Under means testing, the upper income workers who pay the most in taxes would receive little or nothing back. Such a move could end up being seen as another form of welfare, thus stigmatizing benefits.

Changing to Price Indexing and the Importance of Replacement Rate

Social Security attempts to provide an average wage worker with a monthly retirement benefit that is roughly 40 percent of his or her final month's paycheck. This is known as "replacement rate," and it varies according to income level. The lowest wage workers have replacement rates that approach 80 percent, while the higher wage workers are only slightly above 20 percent. The replacement rates differ because it is assumed that lower wage workers will depend on Social Security for much more of their retirement incomes, while higher income workers will have other sources of retirement income in addition to Social Security.

Shifting from wage indexing to price indexing (see above) would allow future workers to receive retirement benefits that have at least the same purchasing power as those of today's workers. However, over time, replacement rates would gradually drop for workers of all income levels. This would especially affect the lowest wage workers who most depend on Social Security. The only way to avoid this would be to couple the change in indexing to a guaranteed minimum benefit that would ensure that lower wage workers receive a benefit that is sufficient to keep their retirement incomes above a certain threshold.

Raising Rate of Return Through Personal Retirement Accounts

The only other alternative to raising Social Security taxes or reducing benefits is to make the existing taxes work harder by investing them in personal retirement accounts. These accounts would allow workers to take advantage of the higher rate of return available to upper income investors. Even if workers only invested their accounts in super-safe federal government bonds, they would still earn almost twice the rate of return available to them under today's Social Security.

Personal Retirement Accounts Would Enable Workers to Build Better Retirement Nest Eggs

Americans should have more to show after a lifetime of work than just memories. They should be able to build up a nest egg in cash that can be used to increase their retirement income or to build a better economic future for their families.

Today's Social Security system provides a stable level of retirement income and protects against catastrophic losses through Old-Age, Survivors and Disability Insurance. But it does not allow workers to accumulate cash savings for their own retirement goals or to pass on to their heirs. This gap needs to be filled. The best way to do this is to establish, as a part of Social Security, a system of personal retirement accounts that are financed with a portion of the existing taxes that now go for Social Security retirement benefits.

Where Would the Money that Goes into a Personal Retirement Account Come From?

There are only two realistic sources for the funds that would go into a Social Security personal retirement account that is part of Social Security. Essentially, the money must come from the existing Social Security taxes that an individual already pays or from new taxes.

- *Add-on Accounts:* Some lawmakers propose introducing new taxes or earmarking revenue from the expected budget surpluses to fund the new accounts. These are usually called "add-on" accounts because the money that goes into them is in addition to the taxes an individual already pays to Social Security. Although this method might improve a worker's retirement income, it means higher taxes and would do nothing to improve an individual's rate of return on Social Security taxes.

- *Carve-out Accounts:* The alternative is to fund the account with money that has been "carved out" or diverted from the taxes that now pay for Social Security retirement benefits. This method would reduce the income to the Social Security trust fund and take a significant step toward tackling insolvency even sooner; it also would make Social Security a much better deal for most Americans. In addition, diverting part of the existing Social Security tax would provide a much more stable source of funding that does not depend on the accuracy of economic forecasts or the ability of Congress to restrain its spending habits.

Limiting the Initial Investment Options Would Reduce Risk

The simplest, and most likely, Social Security accounts would be individually owned and privately managed, with a limited number of investment options. Participants would be allowed to choose among a stock index mutual fund similar to a Standard & Poor's 500 Index mutual fund, a high-grade corporate bond fund, or a super-safe government bond fund that invests in the new Series I Savings Bonds. These bonds are designed specifically for retirement savings and pay an inflation-adjusted rate of return that is guaranteed for the 30-year life of the investment.

Initially limiting the number of investment options would have two advantages. First, limiting the number of investment options reduces risk. Your brother-in-law's hot stock tip is not usually the best road to retirement security. An index fund would provide the returns associated with the equity markets without the hazard and expense of picking individual stocks. Studies show that while individual stocks tend to have wide swings in value, long-term investments that track the growth of the overall stock market have very little risk. Ibbotson Associates, a noted stock market research company, has shown that the overall stock market has increased in value over every possible 20 consecutive year period since 1926.

Second, limiting the number of investment choices would also allow people who are not currently managing their own money to gradually learn to invest. Since any of the three basic options would earn substantially more than the current Social Security system does, any choice would improve their retirement incomes.

The Thrift Savings Plan: An Example of How a Personal Retirement Account Could Work

One existing example that shows how a system with limited investment choices could work is the Thrift Savings Plan (TSP), a retirement investment fund for federal employees and uniformed military personnel, has a different set of investment options. TSP offers five funds that the worker can divide his or her contributions among.

Currently, TSP consists of five funds: The G Fund (Government Securities Investment Fund) is invested in special issues of U.S. Treasury securities. The F Fund (Fixed Income Index Investment Fund) is invested in the Barclays U.S. Debt Index Fund, which tracks the Lehman Brothers U.S. Aggregate bond index. The C Fund (Common Stock Index Investment Fund) is invested in the Barclays Equity Index Fund, which tracks the S&P 500 stock index. In May 2001, TSP added an S Fund (Small Capitalization Stock Index Investment Fund), invested in the Barclays Extended Market Index Fund which tracks the Wilshire 4500 stock index. It also added an I Fund (International Stock Index Investment Fund), which is invested in the Barclays EAFE Index Fund, which tracks the Europe, Australasia, and Far East (EAFE) stock index.

If the worker fails to decide which fund to invest in, his or her money goes into a fund that invests in federal government bonds. While it is marginally more expensive to allow workers to divide their money among differing funds rather than having it all in one fund, the TSP approach is also a viable option for Social Security personal retirement accounts.

Administrative Costs

Can such a PRA system be developed at a cost that does not eliminate all of its benefits through high administrative costs?The answer should be yes. History shows that administrative costs are highest when a system is first implemented and start-up costs must be covered. As time goes on, administrative costs decline significantly. This is true in the case of 401(k) accounts, the Thrift Savings Plan for federal employees, and even Social Security.

Over the years, for example, the administrative costs of 401(k) plans have decreased despite the growth in investment options and the level of personal service. Although the costs of specific plans vary according to each plan's complexity and size, as well as the type of assets in which the plan is invested, many large companies have been able to keep their annual costs as low as 0.3 percent by offering only a limited number of broad-based funds.

The federal Thrift Savings Plan, which is a privatized retirement plan open only to federal employees, has seen an even more dramatic reduction in administrative costs. Since the system started in 1988, administrative costs have decreased by 76 percent.

Social Security showed similar reductions during its formative years. In 1940, when the system first began to pay benefits, its administrative costs equaled 74 percent of all Old-Age and Survivors' Insurance (OASI) benefits paid. In 1945, this figure had declined to 9.8 percent. Today, administrative costs make up only 0.64 percent of payments from the OASI trust fund. Even though Social Security's structure has changed over the years so that this is not a perfect comparison, it does give analysts an idea of the possible size of the reduction.

The best estimate of the cost of a PRA was made by State Street Trust. Using proprietary data the bank accumulated form its experience in managing a host of pension plans, State Street estimates that the annual cost per person of $3.38 to $6.58 annually. Expressed in percent of assets under management, the annual fee is 19 to 35 basis points annually. This fee assumes an annual contribution per worker equal to two percent of his or her gross earnings. It drops significantly if that contribution climbs to an amount equal to four percent of earnings. State Street's findings were reviewed and accepted by the U.S. General Accounting Office as accurate.

How Retirement Accounts Would Be Regulated Is Key to Their Success

Regulation that is too strict would prevent account owners from earning enough on their investments for a better retirement income. It could also discourage private management firms from participating in the program. On the other hand, regulation that is too loose could result in investment choices that are either too risky or otherwise questionable for a retirement account. It could also result in participation by undercapitalized or inexperienced investment managers. Either over-regulation or under-regulation could cause the program to fail.

Personal retirement accounts should be carefully regulated and closely monitored. However, that job should be entrusted to an existing financial regulator such as the Securities and Exchange Commission. Under no circumstances, should it go to the Social Security Administration (SSA).

While SSA does an admirable job of calculating and delivering benefits to millions of Americans, it has no experience whatever in investing. The Department of the Treasury collects taxes for SSA, and the Bureau of the Public Debt turns any taxes that are not immediately spent into special issue Treasury bonds. But at no point does the SSA have substantive dealings with financial markets or private-sector financial institutions.

In fact, allowing the SSA to regulate personal retirement accounts could create a conflict of interest. If Congress created a voluntary system of personal retirement accounts, where workers can choose whether they wish to divert a portion of their Social Security taxes into such an account or remain in the existing SSA-administered version, that would place the two systems in competition with each other. If SSA had the ability to regulate personal retirement accounts, it could be tempted to use its authority to obstruct the development of these accounts with unnecessarily heavy regulatory burdens.

As a result, SSA should have no role in regulating financial institutions that manage personal retirement accounts. A massive bureaucracy that can take years to determine eligibility for disability claims simply does not have the expertise or ability to understand the innovative and rapidly changing financial world. SSA could add nothing positive either to funds management or to consumer protection, and it could do a great deal of damage by misunderstanding the nature of the business.

Fixing the System Now Will Cost Less than Waiting

There is no easy solution to Social Security's problems. No matter what, future taxpayers will bear a

significant additional burden to pay the benefits of that time's retirees. The only real questions involve when the annual deficits will begin, how big they will be, and how long they will last.

At the same time, it is important to stress that reformers should not just focus on "fixing" or "balancing" the program's deficit. A $25 trillion unfunded liability proves that the current system is unsustainable, but raising taxes or cutting benefits would serve only to compound Social Security's other crisis—poor and declining returns for taxes paid—by making the program an even worse deal for workers. Instead, that huge number should provide further evidence of the need to transform Social Security into a system of personally owned retirement savings accounts.

Of course, the benefits of personal retirement accounts would take some time to develop. Even if a taxpayer were allowed to begin them tomorrow, the accounts would not grow large enough to offset any significant amount of the traditional benefits for a good 20 to 30 years.

Without reform, Social Security spending will exceed projected tax collections in 2017. These deficits will quickly balloon to alarming proportions. After adjusting for inflation, annual deficits will reach $96 billion in 2021, $205 billion in 2026, and $324 billion in 2034. After that, these deficits will continue to grow even larger.

With reform, Social Security cash flow deficits will begin sooner, but they will also eventually end. While the exact year deficits begin and their size will depend on the plan, overall, it would be much less expensive to reform Social Security than to do nothing.

Under the current Social Security, it will take almost $6 trillion (in 2002 dollars) just to repay the trust fund, with total cash flow deficits through 2077 running in excess of $25 trillion. According to the Social Security Administration actuaries, it will take only about $7 trillion to fix the system permanently. That number is SSA's estimated transition cost for both Option 2 from the President's Commission to Strengthen Social Security and for the DeMint-Armey reform plan.

Where Would the Money for Transition Costs Come From?

As a practical matter, the costs of transitioning to personal retirement accounts will come from the same source as the money that will be necessary to repay the Social Security trust fund. The two main sources will be general (non-Social Security) revenues and borrowing it by issuing government bonds. Even the amounts are similar: $6 trillion (in 2002 dollars) to repay the Social Security trust fund or $7 trillion to completely reform the current system and add personal retirement accounts. The only question to be resolved is when the payments will start and whether the system is actually reformed once and for all or if those trillions are spent merely to delay insolvency.

Practical Ways to Deal With Stock Market Risk

In the real world, retirement investments have risk-limiting features to reduce losses from market fluctuations. Such features could be part of Social Security personal retirement accounts as well.

- *Different portfolios for older and younger investors:* Today, investment advisors regularlystructure retirement accounts so that as workers age, they shift more funds into fixed-income investments. Through this process, they tend to lock in earnings by decreasing the proportion of investment in stocks. A recent survey of 401(k) plans shows that investors in their sixties invest less of their portfolios in equity funds (44 percent vs.63 percent for investors in their twenties) and much more (23 percent vs.8 percent) in guaranteed investment contracts and similar instruments that pay a fixed interest rate. This lesson can be applied to Social Security personal retirement accounts also.

  This is significant because decreasing the proportion in stocks reduces the potential for short-term loss. Younger investors need to invest most of their assets in stocks to get higher returns, but those closer to retirement need to reduce the chance that a sudden market shift will affect them. In the second quarter of 2002, older investors nearing retirement whose money was invested 40 percent in stocks and 60 percent in

tax-exempt bonds would have seen their assets decline only by about 2.9 percent.

- *Index-type funds rather than individual stocks:* Stock index funds that track the entire market are much less volatile than individual stocks and funds that track only one economic sector. On August 21, 2002, Standard & Poor's 500 index rose by 1.3 percent, but that one day sawPure Resources, Inc. stock increase by 34.2 percent and Radio Shack stock decline by 16.4 percent. While individual stocks come and go and individual companies that make up an index change frequently, the index continues.
- *Long-term investments in stocks:* Retirement investors should be encouraged to buy and hold stocks for long periods; thus, legislation creating personal retirement accounts should discourage short-term trading. Though stock returns fluctuate widely from year to year, earnings on stocks held for 20 years or more have always gone up. This is significant because retirement assets are usually held for 20 to 40 years. The investment analysis firm of Ibbottson & Associates has found that, since 1926, large company stocks have had returns that varied from +53 percent in 1954 to -43 percent in 1931; when the same stocks were held for 20 consecutive years, they had positive average annual returns, even during the Great Depression. Longer is even better. Jeremy Siegel of the Wharton School at the University of Pennsylvania found that, since 1871, stocks held for 30 years have always outperformed bonds and Treasury bills.
- *Blended portfolios to smooth out risk and returns:* Funds managers should allow workers to invest retirement account funds in mixed portfolios of stocks and other investments. Such portfolios would ease concerns about market fluctuation, since some money would be invested in safer income instruments. As the demand for retirement investment and annuity products grows, new instruments that combine reduced risk with higher returns are being developed. One securities firm has developed an inflation-indexed annuity with a survivor's benefit. Insurance companies are developing packages that include both investments and life insurance. Any of these products would be suitable for personal retirement accounts.
- *Series I Bonds or similar investments:* Legislation creating personal retirement accounts also should allow workers who wish to avoid any risk to invest in U.S. Treasury I Bonds, which currently pay 2.0 percent plus inflation and have no administrative charges.

Reform in the United States and Other Countries

For the most part, reforms in other countries take the form of gradually replacing government-run schemes with retirement systems based on mandatory private savings. Some countries' Social Security systems are made up entirely of mandatory savings, while others use these accounts for only a portion of their systems. In each case, personal retirement accounts invested in private-sector assets have become financially rewarding for individual workers as well as a boost to the national economy.

Social Security Was Not Invented in the United States

Other country's experience is important because Social Security was not invented in the United States. In fact, when the United States finally acted in 1935, it was one of the last industrialized countries in the world to adopt a Social Security system. The first Social Security system covering retiree's benefits was established in 1889 in Germany by then-Chancellor Otto von Bismark. By the time the United States acted 46 years later, Social Security-type systems had already been established in 54 other countries. In addition to large industrialized countries such as France and Great Britain, smaller countries such as Bolivia, Chile, India and Nicaragua had programs similar to Social Security before the United States.

Just as the United States lagged behind much of the rest of the world in establishing a Social Security system, it is also behind many other countries in acting to resolve the system's problems. Already, well over 20 countries have established some form of personal retirement account as part of their systems. Among the most recent of these countries is Germany, which originated the idea of Social Secu-

rity in the first place. The United States can learn a great deal by studying the actions of other countries in reforming Social Security.

Some U.S. Workers Already Participate in Successful Private Pension Plans

More than 1 million state and local government workers across the United States are exempt from paying Social Security taxes, and participate instead in private pension plans. The experience of these 1 million workers—who include state employees in Colorado, Maine, Nevada, and Ohio, teachers in California and Ohio, and city employees in San Diego and Los Angeles—confirms that retirees can enjoy a more prosperous retirement if their pension savings can be invested in private-sector assets.

- These government workers can receive 3.3 to 7.5 times more in retirement income than Social Security can provide to workers with equal earning histories.
- Workers in these local government plans earn a much higher rate of return on their retirement contributions than is earned by people who are forced to participate in Social Security.
- Perhaps the most compelling evidence for totally personal savings plans comes from the experience of workers for three Texas counties: Galveston, Brazoria, and Matagorda. In the early 1980s, all three governments allowed their workers to exercise their option to withdraw from Social Security and invest in a private retirement savings plan. (Perhaps fearing that other municipal governments might take the same step, Congress revoked this option in 1983.) Galveston County's workers voted to privatize their retirement pension by an astounding margin of 78 percent to 22 percent. The results have been spectacular. For about the same amount of money that it would cost to participate in Social Security, these county workers now receive greater benefits than they would have gotten from Social Security.
- The fire department in Houston, Texas has been operating a retirement accounts system since 1937. The system has more than $1 billion in real assets, and retired firefighters enjoy more than three times the income they would have received from Social Security.
- The City of San Diego established a personal accounts plan for its employees in 1981. Its employees have both higher retirement income and much receive much more for their contributions than they would under Social Security.

Chile and Latin America

In 1924, Chile became the first country in the Western Hemisphere to create a government-run pension system. Over time, however, costs exploded, unfunded liabilities expanded, and high taxes stunted job creation. By 1981, the Chilean government decided that the only way to solve the problem was to phase out its Social Security system and replace it with mandatory private savings.

Under Chile's private system, workers are required to deposit 10 percent of the first $22,300 of their income in the approved pension fund of their choice. They may also voluntarily contribute up to an additional 10 percent of income into the same account. Anyone in the work force in 1981 had the choice of joining the new system or staying in the old one. If these workers switched to the new system, they received what was called a "recognition bond" acknowledging their contributions to the old system. When those workers retire, the government cashes the bonds and adds the money to their retirement savings. For workers with very low incomes or other problems that prevent them from saving enough, the Chilean government also provides a safety net. The Chilean Congress has established a minimum pension equal to about three-quarters of the pre-retirement income for a minimum-wage worker and 25 percent of pre-retirement income for an average-wage worker.

More than 90 percent of Chile's older workers who could have chosen to participate in the government-run Social Security scheme chose the private options instead. Over 95 percent of workers currently participate in the system. The retirement saving assets of these workers totals over $34 billion—about 42 percent of Chile's GDP.

Those who participate over their working years will be able to retire with an average annual income worth 70 percent of their pre-retirement income—

more than three times the amount promised under the old system. Over the last 18 years, the average real rate of return on retirement accounts is about 11.3 percent.

Considering the stunning success of Chile's personal accounts system, it is no surprise that other countries throughout Latin America also are adopting this approach. Argentina, Bolivia, Colombia, El Salvador, Mexico, Peru, and Uruguay have decided to establish mandatory savings plans. In addition, Poland established a similar system in March 1999. Although not all of these plans are identical in their details, they share a common feature: The superior performance of private investment gives senior citizens a safer and more secure retirement income.

Australia's Successful Superannuation

In 1992, the Australian government created a system of mandatory private pensions, known as the "Superannuation Guarantee," for all workers. Under this system, which was phased in completely in 2002, workers will contribute 9 percent of their income to personal retirement accounts.

By March 1999 there was already Au$387 billion (about US$251 billion) in these accounts. Workers have considerable freedom to invest their own savings or, if they prefer, to choose from more than 250 professionally managed pension funds. In addition, the Australian government, like the government of Chile, will continue to provide a safety-net pension for those whose earnings are too low to fund an adequate private pension.

Even though Australia's Superannuation Guarantee plan is still young, it is extremely popular. The benefits that have begun to materialize herald a significant long-term improvement in the Australian economy. For example:

- *More income for retirees:* Average-wage Australian workers can expect to retire with two to three times the income they would have had under the original government-run system, depending on the level of additional voluntary savings and the earnings performance of the superannuation funds.
- *Increased national savings:* The overall savings rate is expected to climb by more than 3 percent of gross domestic product (GDP) by 2020.
- *Reduced pressures on the budget:* Because eligibility for taxpayer-financed age pensions is now means tested, the higher incomes made possible by Superannuation Guarantees will lead to substantial budget savings. Government spending on age pensions will reach only 4.72 percent of GDP in 2050, one-third less than would have been needed had the government chosen to provide an American-style universal Social Security retirement benefit. (In the United States, Social Security retirement outlays are expected to consume 5.59 percent of GDP by 2050.)

Big Benefits in Britain

The United Kingdom has a two-tiered retirement system. All workers must participate in a traditional government Social Security program that provides a minimum income upon retirement. The second tier, however, allows workers to choose either additional Social Security coverage or private options that must guarantee workers at least the same benefit level that they would have received if they had remained in the government system.

- Because the private pension funds will provide more retirement income, more than two-thirds of British workers have exercised this option.
- To help finance their private savings (and because they agree to forgo the second tier of government pension payments), workers who choose the private option receive a tax reduction. The exact amount of the tax rebates varies from year to year.
- Britain's private pension pool—which already is worth over £830 billion (over $1.4 trillion in U.S. dollars)—is slightly more than the size of the British economy. In fact, it is larger than the private pension funds of all other European countries combined.
- "The OECD [Organization for Economic Cooperation and Development] forecast each country's national debt assuming they continue with their present pensions systems and levels in taxes and charges. By 2030 in France and Germany, the national debt will have about doubled and will exceed national income. In Japan, which is

> aging particularly fast, debt will reach three times national income. By contrast, Britain's second tier funded pensions place us in a unique position. The OECD forecasts that we will have paid off our entire national debt and started to build up assets."

Sweden, Germany, and Other European Examples

Numerous other countries are moving in the direction of personal retirement accounts. Workers in Sweden, for example, set aside 2 percent of their income in personal retirement accounts. This may be small in comparison to the government's portion, but it is noteworthy in a nation known as a cradle-to-grave welfare state. Other European countries with Social Security systems that include some form of personal retirement accounts Denmark, Slovenia, Hungary, Poland, Italy, Switzerland, and Finland.

Most recently, Germany, which invented Social Security, has begun to implement reform that will add a personal retirement account element to its system. This is especially significant because such a move had been considered to be politically impossible for years, yet was passed under a Social Democratic Party government.

Expansion in the Future

In addition to Australia and Latin and South America, personal retirement accounts are also appearing in other areas. The former Soviet state of Kazakhstan has already implemented this type of reform, and Russia itself is developing a plan that will add personal retirement accounts to its system. The most significant change will occur in China, where its Communist government is on the verge of requiring workers to open personal retirement accounts as part of their Social Security system.