Congressional CBO Budget Office
Summary

Social Security Policy Options

Social Security, the federal government's largest single program, provides benefits to retired workers (through Old-Age and Survivors Insurance, OASI), to people with disabilities (through Disability Insurance, DI), and to their families as well as to some survivors of deceased workers. Those benefits are financed primarily by payroll taxes collected on people's earnings. In 2010, for the first time since the enactment of the Social Security Amendments of 1983, Social Security's annual outlays will exceed its annual tax revenues, the Congressional Budget Office (CBO) projects. If the economy continues to recover from the recent recession, those tax revenues will again exceed outlays, but only for a few years. CBO anticipates that starting in 2016, if current laws remain in place, the program's annual spending will regularly exceed its tax revenues.

Social Security's dedicated revenue stream sets it apart from most other federal programs in that the dedicated revenues are credited to trust funds that are used to finance the program's activities. Interest on the balances of those funds also is credited to the funds (which often are treated collectively as the OASDI trust funds). CBO estimates that, unless changes are made to the system, the trust funds combined will be exhausted in 2039. At that point, the resources available to the Social Security program will be insufficient to pay full benefits as they are currently structured.[1]

This CBO study first provides an overview of Social Security and discusses some criteria for evaluating proposals to change the system. It then presents a variety of options for changing the Social Security system and analyzes the financial and distributional effects of those options—that is, how they would affect Social Security's finances and how they would alter the benefits paid to people in various earnings categories and people born in various decades.

The Outlook for Social Security's Finances

As the population of the United States continues to grow older, the number of Social Security beneficiaries will continue to rise, and the program's outlays will increase faster than its revenues. Long-term projections are unavoidably uncertain but, under a broad range of assumptions, benefits that are scheduled under current law will consistently exceed revenues.

CBO projects that beginning in 2039 the Social Security Administration will not be able to pay those scheduled benefits, however. If revenues were not increased, benefits would need to be cut by about 20 percent in 2040 to equalize outlays and revenues. Those proportionately lower payments, which would be made to all Social Security recipients once the trust funds were exhausted, are known as payable benefits.

A commonly used summary measure of the system's long-term financial condition is the 75-year actuarial balance—a figure that measures the long-term difference between the resources dedicated to Social Security and the program's costs under current law. The actuarial balance is the value of Social Security's revenues over the 75-year period, discounted to their value in current dollars, plus the current balance in the OASDI trust funds, minus the present value of future Social Security outlays, minus the value of a year's worth of benefits as a reserve at the end of the period.[2] CBO estimates the 75-year actuarial balance to be -0.6 percent of gross domestic product (GDP); that is, under current law, the resources dedicated to financing the program over the next 75 years fall short of the benefits that will be owed to beneficiaries by

1. See Congressional Budget Office, *The Long-Term Budget Outlook* (June 2010), Chapter 3.

about 0.6 percent of GDP.[3] That figure is the amount by which the Social Security payroll tax would have to be raised or scheduled benefits reduced for the system's revenues to be sufficient to cover scheduled benefits. In other words, to bring the program into actuarial balance over the 75 years, payroll taxes would have to be increased immediately by 0.6 percent of GDP and kept at that higher rate, or scheduled benefits would have to be reduced by an equivalent amount, or some combination of those changes and others would have to be implemented.

The actuarial balance averages the smaller deficits that would occur near the beginning of the projection period and the larger ones that would occur near the end. In 2084, scheduled outlays would exceed revenues by 1.4 percent of GDP.

Policy Options

In this study, CBO analyzes 30 options that are among those that have been considered by various analysts and policymakers as possible components of proposals to provide long-term financial stability for Social Security. The options follow the convention of not reducing initial benefits for people who are currently older than 55, and all would directly affect outlays for benefits or federal revenues dedicated to Social Security.

The options fall into five categories:

- Increases in the Social Security payroll tax,
- Reductions in people's initial benefits,
- Increases in benefits for low earners,
- Increases in the full retirement age, and
- Reductions in the cost-of-living adjustments that are applied to continuing benefits.

Each option is analyzed in isolation, although most proposals to make substantial changes to Social Security combine several provisions. Many options would interact with one another, so combining them might cause changes to the overall finances of the system that are larger or smaller than would be produced by a simple sum of the effects of several discrete options.

This list of options is far from exhaustive. It does not include changes that would draw on general government revenues, create individual accounts, or change the trust funds' investments. Other than an increase in the Social Security payroll tax, changes to federal tax policy are not considered. The options do not include any that apply only to people who receive DI benefits, although some of the options would affect OASI and DI beneficiaries alike.

Effects of the Options

This study analyzes the overall effect of each option on the finances of the Social Security system. Some options, such as those that would apply the payroll tax rate to all earnings or those that would index initial benefits to prices, would more than eliminate Social Security's actuarial deficit; others would have far smaller financial effects (see Summary Figure 1).

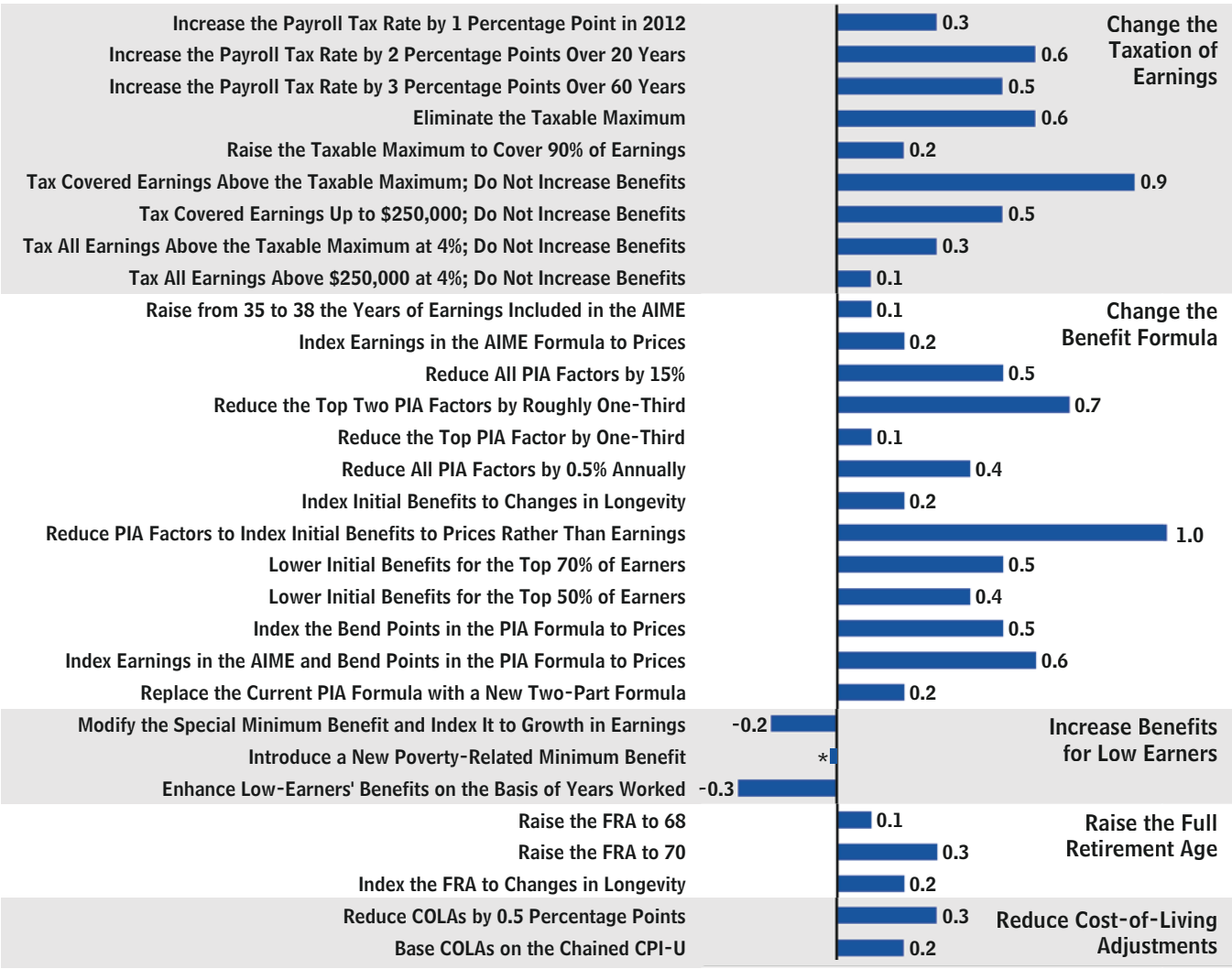
This study also analyzes the options' effects on taxes that would be paid and benefits that would be received by various groups of program participants. For that distributional analysis, participants are grouped by the amount of their lifetime household earnings and by their birth cohort (that is, by the decade in which they were born). Those distributional effects of the options are measured relative to the outcomes that would result both from scheduled benefits and from payable benefits under current law.

2. CBO discounts those values using a real (inflation-adjusted) discount rate of 3 percent, equal to CBO's estimated long-term interest rate used to compute interest credited to the Social Security trust funds. The actuarial balance is calculated on the basis of Social Security's scheduled benefits, which are the benefits specified under current law without regard to the balances in the system's trust funds. Scheduled benefits are used in this study's analysis of the system's finances because, by definition, the system is in financial balance with payable benefits, which would be set so as to eliminate any system deficit.

3. The projected actuarial balance can also be expressed as -1.6 percent of taxable payroll.

Summary Figure 1.

Effects of the Policy Options on the OASDI Trust Fund Actuarial Balance



Source: Congressional Budget Office.

Notes: The actuarial balance is the present value of revenues plus the OASDI trust fund balance at the beginning of 2010, minus the present value of outlays from 2010 to 2084, minus a year's worth of benefits as a reserve at the end of the period, expressed as a percentage of the present value of GDP over the period.

The AIME for a retired worker who reaches age 62 after 1990 is calculated on the highest 35 years of earnings on which that worker paid Social Security taxes (up to the taxable maximum, $106,800 in 2010). Earnings before age 60 are indexed to compensate for inflation and for real (inflation-adjusted) growth in wages; earnings after age 59 enter the computations at nominal values. Dividing total earnings by 420 (35 years times 12 months) yields the AIME.

The PIA is the monthly payment to a worker who begins receiving retirement benefits at the full retirement age or to a disabled worker who has never received a retirement benefit reduced for age. For workers who turn 62, become disabled, or die in 2010 (for calculation of survivor benefits), the PIA formula is 90 percent of the first $761 of the AIME plus 32 percent of the AIME between $761 and $4,586 plus 15 percent of the AIME over $4,586. Those percentages constitute the PIA factors.

A COLA is an annual increase in benefits indexed to consumer prices. Under current law, the COLA equals the percentage increase in the CPI-W; the chained CPI-U is an alternative measure of inflation.

OASDI = Old-Age, Survivors, and Disability Insurance; GDP = gross domestic product; AIME = average indexed monthly earnings; PIA = primary insurance amount; FRA = full retirement age; COLA = cost-of-living adjustment; CPI-W = consumer price index for all urban wage earners and clerical workers; chained CPI-U = chained CPI for all urban consumers; * = between -0.05 percentage points and zero.

Some options, such as an across-the-board increase in the payroll tax rate or a flat reduction in benefits, would affect all participants proportionately, but some options would have disparate effects on people in different earnings groups. For example, some options would primarily affect people with higher lifetime earnings by placing an additional tax on earnings above a threshold or by increasing the progressivity of the Social Security benefit formula.

Many options with similar financial effects in the aggregate would affect older and younger generations differently. In particular, the timing of the changes would affect their impact on different generations (as well as the magnitude of the change necessary to bring the system into balance). Some options, such as one that would reduce benefits by a flat 15 percent, would take effect in a single year and would affect all future beneficiaries the same way. Others would be phased in and, initially, would have only small effects. For example, a policy that gradually reduced benefits would have a much larger effect on people whose benefits began in 2040 than it would on those whose benefits began in 2020. Raising tax rates would increase the amounts paid by younger people but make little difference in the sum of taxes paid over a lifetime by people who already have left or are about to leave the workforce.