

**SOCIAL SECURITY: ACHIEVING  
SUSTAINABLE SOLVENCY**

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**HEARING**  
BEFORE THE  
**COMMITTEE ON FINANCE**  
**UNITED STATES SENATE**  
ONE HUNDRED NINTH CONGRESS  
FIRST SESSION

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MAY 25, 2005  
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## **SOCIAL SECURITY: ACHIEVING SUSTAINABLE SOLVENCY**

**WEDNESDAY, MAY 25, 2005**

U.S. SENATE,  
COMMITTEE ON FINANCE,  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:05 a.m., in room G-50, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Lott, Santorum, Crapo, Baucus, Conrad, Lincoln, Wyden, and Schumer.

### **OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. Today's hearing is the third of a series that we are having on Social Security. Just for a little bit of history, our first hearing focused on the long-term outlook of Social Security, and the second focused on plans to achieve sustainable solvency, and to do that with or without individual accounts, as the President has suggested individual accounts.

Today's hearing will focus on a menu of options, of which I suppose you could tell me that there are 100 or more out there. But we obviously cannot deal with 100 or more, but we have a menu of options to achieve sustainable solvency and to address the potential payroll tax gap.

The menu of options was developed by the Congressional Budget Office. However, I want it very clear that I did request the Congressional Budget Office to score each of the menus to reflect economic and Democratic—demographic assumptions. [Laughter.]

Senator BAUCUS. We appreciate that, Mr. Chairman.

Senator CONRAD. That is good. That is progress.

Senator BAUCUS. All in the spirit of bipartisanship. We appreciate that.

The CHAIRMAN. You know, when you have friends like these folks, you do not really need any enemies. [Laughter.]

Demographic assumptions in the latest Social Security trustee report.

Now, I made this request to the CBO for two reasons. First, the Social Security trustees are required by law to report each year on the actuarial status of Social Security.

I do not believe that we want to adopt a reform plan based on more optimistic CBO assumptions only to have the trustees tell us in their next report that we did not accomplish our intended goals,

à la the debate between the Chief Actuary of CMS and CBO of the last 3 or 4 years.

The second reason that I asked is, when it comes to Social Security, I believe that we should always err on the side of caution. Using overly optimistic assumptions is exactly what brings us here today.

I say that only because of what I believe and the caution I have, not because I have any argument with CBO or the trustees on how they arrived at their figures, because who are we? We are dealing with professionals, and these are the best honest figures that they can give us.

Now, we know Social Security was enacted a long time ago, in 1935. It was paying benefits in 1940. Over the next 3½ decades beyond the 1930s and 1940s, Congress expanded coverage and increased benefits on an ad hoc basis.

By the late-1960s, there was growing interest in adopting automatic cost-of-living adjustments, but there was a significant impediment to doing so, because, since the beginning, the actuaries who prepared long-range cost estimates for Social Security had utilized an actuarial technique known as—and these are their words—level earnings assumptions.

Basically, the actuaries assumed wages would remain fixed at their current level forever into the future. In 1935, that was not an unreasonable assumption because, in 1935, wages were still below the level that had prevailed in the decades of the 1920s.

The actuaries believed this assumption imposed a major fiscal discipline and provided a cushion against unanticipated events. Congress was willing to go along, because, as time passed and wages grew, it was able to periodically dispense then a windfall in the form of higher benefits voted by Congress.

Despite the availability of such windfalls, critics began to suggest a new approach being needed. They pointed out that rising inflation imposed an undue burden on Social Security beneficiaries who were forced to wait on Congress to enact a benefit increase. The proposed solution was what we have today, the automatic cost-of-living raise.

The idea of indexing benefits to prices, or even wages, had been contemplated for several years, but the implementation of an automatic benefit increase was incompatible with the level earnings assumption used since 1935. Long-range projections based on rising benefits and level wages would show large and growing deficits.

So, critics began a campaign to discredit the level earnings assumption and adopt something we call “dynamic assumptions.” This campaign led to the 1969–1971 Advisory Council recommendations that Social Security projections be based on assumptions that earnings would rise in the future.

By adopting dynamic assumptions, Social Security suddenly appeared to have a significant surplus. But unlike the windfall that resulted from an actual wage increase, the surplus under dynamic assumptions was merely assumed.

Nevertheless, several members of Congress seized on the Advisory Council’s recommendations of 1969–1971 and urged an immediate 20 percent across-the-board increase, accompanied by automatic benefit increases thereafter.

Bypassing the normal committee process, an indexing amendment was offered on the Senate floor to a must-pass bill increasing the statutory debt limit. It passed overwhelmingly in June of 1972.

The Congressional debate that preceded passage of the indexing amendment focused on keeping benefits up with inflation. For those who were already collecting benefits, the amendment delivered as promised.

But for those who were not yet receiving benefits, the amendment had an entirely different effect: depending on the relative change in wages or prices, initial benefits for newly eligible recipients would rise faster than prices, or even faster than wages.

This critical distinction between initial benefits and subsequent benefits might have gone unnoticed for years, but economic and demographic forces soon intervened to reveal that the formula was flawed and the goal of wage-indexing was no longer affordable at the scheduled payroll tax rate.

The 1972 amendment was based on two assumptions: that wages would rise nearly twice as fast as inflation, and that the number of births would remain near the baby-boom level. Under these two conditions, the initial benefits would rise in line with wages and there would be plenty of workers to support each beneficiary without raising the payroll tax beyond the 12.5 percent.

However, the decades of the 1970s saw rising inflation and the end of the baby boom. The flawed formula caused benefits to rise faster than wages and the declining birth rate resulted in projected decline in the ratio of workers to beneficiaries. As a result, Social Security trustees began to report ever-rising deficits.

In response to these trustees' reports, the Senate Finance Committee and Ways and Means Committee of the House requested appointment of an independent consultant panel to examine the problem and develop alternatives.

The panel issued its report in 1976 and recommended that Congress index the initial benefits to prices instead of wages. But advocates of higher benefits sought to replace the flawed 1972 formula with another wage-indexing formula that was less erratic and unpredictable.

Ironically, the flaw of the 1972 formula became its biggest asset, since between 1972 and 1977 the projected costs more than doubled, from 12 percent to 24 percent of taxable wages.

Advocates of wage-indexing sought to portray their version of wage-indexing as significant savings because it costs only 18 percent of taxable wages, which is probably where it is today.

Advocates of wage-indexing persuaded Congress to adopt their plan in 1977 by simultaneously arguing that it was cheaper than current law and more generous than price-indexing.

The fact that changing demographics had rendered the promised level of wage index benefits unaffordable at the scheduled payroll tax rate of 12.5 percent did not seem to make any difference.

Advocates dismissed the projections of future deficits by suggesting that economic and demographic changes might solve the problem. If not, then Congress would have plenty of time to think of something.

Well, here we are today, still trying to think of something to do about what we know is the issue out there, that was still an issue predicted by some people in 1977.

Members of this committee will no doubt find the menu of options presented by our witnesses today less than appetizing. And, of course, everybody is welcome to put their own options on the table, and we should consider all options, but the time has come to address the issue.

So let me conclude by sharing with you the admonition given to this committee by that consultant panel already referred to back in 1976: "This panel gravely doubts the fairness and the wisdom of now promising benefits at such a level that we must commit our sons and daughters to a higher tax rate than we ourselves are willing to pay."

Senator Baucus, I know I took a long time. You take as long as you want.

**OPENING STATEMENT OF HON. MAX BAUCUS,  
A U.S. SENATOR FROM MONTANA**

Senator BAUCUS. Thank you. Thank you very much, Mr. Chairman. I very much thank you for calling this hearing focused on extending the life of Social Security without private accounts.

As you know, Mr. Chairman, in the view of many of us, that last part is key. If we are to have any hope of enacting legislation in this Congress to strengthen Social Security, then the President needs to leave his effort to privatize Social Security behind.

Once the President disavows private accounts in Social Security, he will find Democrats willing and able to join him in an effort to strengthen Social Security for centuries to come.

Social Security is America's most important domestic program. If Social Security did not exist, most of our seniors would live in poverty. With Social Security, just 1 in 10 seniors do.

Under the current law, the Congressional Budget Office projects that Social Security can pay full benefits to 2052. The year after that, Social Security will be able to pay about 80 percent of benefits.

We clearly need to improve Social Security's finances so that it will be able to pay full benefits after 2052, but we do not need to make drastic changes.

Unfortunately, we are going to be hearing about drastic changes today. The testimony of the Director of the Congressional Budget Office will provide data on three options, options to achieve sustainability and to sustain solvency of the Social Security trust fund.

Unfortunately, each option results in deep benefit cuts for both middle-class and low-income Social Security beneficiaries. I do not think that these deep cuts would be acceptable to most of the American people.

Let me be more specific. The first option put forward is price-indexing, just as in Model 2 of the President's Social Security Commission. The President's advisors suggested in January that the President liked this option, although they have backtracked since then.

CBO's testimony indicates that this option reduces all benefits by about 50 percent after 63 years. These are huge benefit cuts. More-

over, these big cuts would also apply to disability benefits and to survivors' benefits when workers die during their working years.

The second option being put forward is similar to the President's partial price-indexing plan. He endorsed this plan in his press conference a few weeks ago. Like the President's proposal, this proposal has deep benefit cuts for the middle class and deep benefit cuts for survivors.

For example, workers with average earnings who are born today and retire at age 65 would have their benefits cut by 31 percent. But this option also cuts benefits for some low-income workers who were protected under the President's plan.

For example, all low-income workers with average career earnings as low as \$15,000 in today's dollars would receive benefit cuts under this newest option. Moreover, the new option would also make deep cuts in benefits for the disabled, as would the President's.

The third option put forward today would raise the retirement age to about 70 years for all workers who are born 10 years from now. Currently, the retirement age will rise to 67. This is a big increase. If that were not enough, the option would also cut benefits by changing the way benefits are indexed.

This would reduce benefits by 27 percent for earners in the middle of the income distribution who were born this year and retire at age 65. Even worse, it would cut benefits for workers in the lowest fifth of the income distribution by 33 percent, and these deep benefit cuts would apply to survivors of deceased workers and to disabled workers as well.

Once you look at the details, I think it becomes clear that these three new options cut benefits for Social Security beneficiaries far too deeply. We need to scour all other ideas for improving Social Security's long-run finances. Regrettably, the President's Social Security plan would also cut benefits far too deeply. It would also add massively to our Federal debt.

The President's plan has two basic parts. The first proposal is to privatize Social Security. The President wants to allow workers to divert some of their payroll taxes out of the Social Security trust fund and into private savings accounts.

He proposes that when these workers retire, they must pay back to the Federal Government all of the money that had been diverted, plus interest, compounded at a rate of 3 percent above the inflation rate. The President would dock retirees' Social Security checks to collect that repayment.

This privatization proposal is a bad idea, for several reasons. First, this makes Social Security's solvency worse—not better, but worse. Suppose we consider Social Security's health over the next 75 years, as has been traditional.

The diversion of funds from the Social Security trust fund takes place during the working years of the individual, but the repayment of the funds first begins after the worker retires. So for some workers, their payment occurs outside the 75-year window. This timing gap worsens Social Security's 75-year solvency.

Coping with this increase in solvency would cause pain. To make up for this added solvency with benefit reductions for retirees, while protecting benefits of survivors and the disabled, the Federal

Government would need to cut retirement benefits across the board by more than 9 percent. That is according to the Congressional Budget Office.

I would further note that the average benefit for a retiree today is about \$11,000. A benefit cut of 9 percent would mean a loss of about \$1,000 a year to that average retiree. So, privatization is a self-inflicted wound to solvency. It does not make sense.

The second problem with privatization is that it would cause a massive increase in the Federal debt. The debt would go up by about \$5 trillion during the first 20 years.

That is because the Federal Government would have to borrow money to buy the stocks and the bonds it would need to put into each worker's private account. The \$5 trillion of new debt would more than double the size of the Federal debt held by the public today.

At some point, all this extra debt would drive up long-term interest rates. This would slow economic growth and reduce our standard of living. This added debt would result in foreigners owning a lot more of our financial assets.

This means that the earnings on these assets would benefit foreigners, not United States residents. Foreigners already own about \$2 trillion of our debt. Privatization would probably double that amount.

Moreover, much of our debt is currently owned by the central banks of foreign countries such as China, Japan, and South Korea. If the dollar were to start dropping even more in value than it already has, these banks might fear that the U.S. debt they owned would start plunging in value. They might feel compelled to sell that debt. This would cause interest rates here to spike, certainly causing a recession.

The third problem with privatization is that it could cause many workers to lose money. Under the President's proposal, if your earnings do not average at least 3 percent above inflation for your working years, you will lose money. But the CBO projects just that, 3 percent, which means if you make even slightly less than that rate of return, you will suffer a loss.

Unfortunately, the President also has endorsed a second bad idea, and that is cutting benefits by changing the indexing of initial benefits. The President's plan would severely cut Social Security benefits for middle-income retirees, as I discussed, and these cuts would occur regardless of whether the worker opts for private accounts—regardless.

That is not the end of it. The President's Chief Economic Advisor, Alan Hubbard, said last week that the President's plan would cut Social Security survivors' benefits as well. He also admitted that, under the President's proposal, disability benefits for workers and their families would not be fully protected.

As bad as privatization is by itself, and as bad as the middle-class benefit cuts are standing alone, they are even worse when they are combined together. Yet, that is what the President is proposing.

As noted earlier, workers who opt for private accounts will have their Social Security benefits reduced when they retire. As noted earlier, the President's plan would cut benefits of middle-class

beneficiaries regardless of whether they had opted for private accounts.

The combination of these two benefit cuts, for a worker born 5 years from now with career average earnings of \$59,000 who retires at age 65, would be a cut of 97 percent. For a worker with career average earnings of \$90,000, the benefit cut would be 100 percent.

Even with these cuts, the President's plan would not come close to eliminating Social Security's insolvency. Under the projections of the Social Security actuaries, which the President is using, this combination would eliminate only about 30 percent of Social Security's financing shortfall over 75 years. The President would have to propose a lot more savings, and probably huge benefit cuts beyond those he has already proposed.

The disadvantages of the President's two proposals, in combination or separate, greatly outweigh any advantages. We need to leave the President's plan behind. Rather, we must scour all the options available to eliminate Social Security's 75-year insolvency shortfall. For example, we need to look at tax compliance with Social Security's employment taxes.

The Joint Committee on Taxation and the Treasury Inspector General for Tax Administration each have made recommendations for improving compliance with employment tax law. The changes that they are recommending would increase income to the Social Security trust fund.

We should not cut the benefits of any law-abiding retiree by 1 dime or raise the taxes of any law-abiding worker by 1 dime until we have done our best to ensure that all taxpayers are complying with current tax law. The same holds true with respect to any improper payments that are being received on the benefit side for the program.

So I look forward, Mr. Chairman, to the testimony and discussion from our very, very fine panel of witnesses. The sooner we get the President's plan behind us, the sooner we can return to the real business of improving Social Security's finances for the long term.

The CHAIRMAN. Thank you very much, Senator Baucus.

We now have a panel, and we will go in the order in which they are seated.

Dr. Douglas Holtz-Eakin, Director of CBO; Dr. Eugene Steuerle, senior fellow, Urban Institute; Mr. Stanford G. Ross, former Commissioner of Social Security; Mr. George Yin, Chief of Staff, Joint Committee on Taxation; and the Honorable Russell George, Office of the Treasury Inspector General for Tax Administration, Treasury Department.

Dr. Holtz-Eakin?

**STATEMENT OF DR. DOUGLAS HOLTZ-EAKIN, DIRECTOR,  
CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC**

Dr. HOLTZ-EAKIN. Mr. Chairman, Senator Baucus, and members of the committee, the CBO is pleased to have a chance to be here today to discuss this important topic of solvency for Social Security.

You have our written testimony. I could not possibly do justice to the attachment, which is a menu of options within the context

of the current system which would affect the future solvency of the system.

I probably could not do justice either to the three particular pieces which we pulled out as stylized components of changes to Social Security in my oral remarks, so I will instead attempt to provide you a road map to that written testimony and look forward to your questions at the end.

I will divide the road map into three pieces. First, implications for aggregate finances for Social Security; second, distributional implications of changes, as I illustrated them in the testimony; and third, the nature of the benefit adjustments which are underneath both the aggregates and the distributional implications.

To begin, Figure 1 in the testimony, and the figure I have put up on the screen, is the current outlook for Social Security, both in terms of current law and also scheduled benefits. As the Chairman noted at the outset, this projection is done using the trustees' assumptions, so it is CBO's mimic of the 2005 trustees baseline.

To review the basics of what I believe is by now a very familiar story, under current law, Social Security at the moment will run a cash-flow surplus. That cash-flow surplus will peak in the near future and then diminish, turning to a cash-flow deficit. In the background, during that period the trust funds will be building up and providing financing for the future.

Within the program itself, going forward until 2044, the cash flow deficits will be financed by transfers from the remainder of the budget to honor the Social Security trust funds, and then in this projection, trust funds will exhaust and benefits will be cut down to match receipts coming in, and there will be a gap between the top dotted line, which is scheduled outlays, and benefits under the program and those which the Secretary of the Treasury will have the legal ability to pay.

So that is the current-law outlook, that is the aggregate finances, and the target for the options that we showed in the written testimony was to transform that outlook into one which had sustainable solvency.

The tactic is to focus on benefit changes which would permit a greater accumulation of trust funds and a slower decumulation out in the cash-flow negative years so that the trust funds do not exhaust under the reform and there are sufficient funds to pay benefits as scheduled in the reformed system out to 2100.

In each case, we have scheduled these to begin in 2012, and thus they would not affect anyone who is currently 55 or older. In each case, we have focused on reducing benefits through a variety of tactics. As noted in the menu in the attachment, there are other ways one could do this. Benefit changes are easy to compare and straightforward. All of the benefit changes will lead to sustainable solvency. They are designed to do that.

All, in fact, will be of sufficient magnitude that, out around 2100, there will be a cash-flow surplus in Social Security. The cost and income lines would not only come together, they will cross.

All share the same Achilles heel of such changes in the current budgetary context, which is that they rely up front on the accumulation of trust fund surpluses and the presumption that those will not be spent elsewhere in an economic sense by the rest of the

budget, and all rely on the future transfers from the unified budget to honor the trust fund in a world where, I will remind you, the current-law promises for Medicare and Medicaid are ramping up much more rapidly and becoming much larger, so they all will evolve in the same budgetary context that has been discussed in the past.

Now, moving to the distributional analysis. Under current law, one can measure the implications in a variety of ways. The measures that we focus on in the testimony are replacement rates: the primary insurance amount (the basic retirement benefit) as a fraction of your average indexed monthly earnings.

We also discuss to a lesser degree some lifetime benefit measures. These are measures that we have produced in the past, and in our outlook for Social Security there is greater detail.

These are not the only measures of benefits. One could look at first-year benefits awarded to retirees. One could look at disability/survivors, and one could certainly look at taxes paid over a lifetime. But given the wide variety of benefit measures, these are the focus of the written testimony.

There is also an issue always in distributional analysis of how you would classify workers. The figure on the screen, which is Figure 3 in the written testimony, shows the implications of different classifications for your measure of distribution under current law.

One possibility is to measure someone by their place in their ability to purchase, and so the top line shows a worker at the middle of the earnings level for 2005, which is averaged indexed monthly earnings of \$2,500, and looks at the replacement rate for a person like that with the same purchasing power and the same lifetime real earnings going forward. You can see that, under scheduled promises, the replacement rate would rise for such an individual going forward.

The insurance amount as a fraction of their earnings would be increasing over time up until, under current law, the dotted line at the bottom, which showed the drop-off when trust funds exhaust and there was a benefit cut.

Alternatively, you could look at the individual and classify them on their relative rank, where do they fit in the income distribution. As the economy gets richer, that same middle-earnings person now would have higher than \$2,500 in purchasing power in the future.

The bottom line in that figure shows you the relatively flat replacement rate that one would depict if you focused on an earner at the middle of the distribution at every point in time in the future as opposed to an earner with exactly the same purchasing power.

So there are alternative measures. We tried to lay them out clearly in the testimony so that the committee can understand them. And in looking at changes in both the distribution and the aggregate finances, the focus of the testimony is on alterations of the current benefit formula. The figure on the screen is the computation of the primary insurance amount for those workers who turn 65 this year.

The key features from the point of view of the computation are that, step one, you calculate average indexed monthly earnings,

typical earnings over a lifetime, where “indexed” in this case is a wage index.

One variation we will show in the reforms is to change that indexing to prices. Having computed that, the formula then consists of three segments with bend points, as we refer to them, and replacement factors. The replacement factors are 90 percent, 32 percent, and 15 percent. The bend points are, at the moment, indexed to go up with wages.

The basic tactic in all of the options that we show you is to alter the pieces that go into this computation, alter the average indexed monthly earnings computation, change the location of the bend points, or alter the replacement factors.

These, again, are not the only options one could choose. As the attachment shows, you could alter retirement ages; you could alter the cost-of-living adjustments during retirement.

So the options that one sees in the written testimony are really three, four if you count current law as essentially a wait-and-reform option where you just let the trust funds exhaust and cut benefits across the board. So, we show that as well in the interest of comparability.

The three we show are, as the Chairman or Mr. Baucus mentioned, price-indexing as outlined by the President’s Commission on Social Security. In the context of this diagram, that amounts to lowering the replacement factors going forward to offset real wage growth. So, the 90, 32, and 15 percent become smaller numbers going forward, and this affects individuals and lowers aggregate benefits as well.

Number two is progressive price-indexing. In the implementation that you have in the written testimony, this is the same for people at the top end as the first option. It is pure price-indexing for the very highest earners.

It is current-law for those who are at the 25th percentile or below, so they are insulated. It is a combination of those two for everyone in between. That has a differential effect across the income distribution, but also serves for lower aggregate benefits.

Then, finally, we show an option in which we alter the computation of the average indexed monthly earnings by moving the index from wage- to price-indexing. We then also change the bend points by indexing those to prices instead of wages, and we alter the entire benefit award for longevity.

Having once made the first two changes, the third longevity change is meant to provide the same lifetime benefits for those living longer in the future as those people would get in the present.

The upshot of these changes is a set of formulas which in each case affects different parts of the income distribution differentially. You can see that in the stylized pictures that we have here. In each case, the formulas lie below the current formula and, thus, reduce the growth rate of benefits and allow sustainable solvency for the system as a whole.

I thank you for the chance to be here today to talk about this important question, where about the only option that we know is not on the table is doing nothing. I look forward to explaining the ones that we have outlined in the written testimony, both from the

implications of the aggregate finances and their distribution consequences for beneficiaries. Thank you.

[The prepared statement of Dr. Holtz-Eakin appears in the appendix.]

The CHAIRMAN. Dr. Steuerle?

**STATEMENT OF DR. C. EUGENE STEUERLE, SENIOR FELLOW,  
URBAN INSTITUTE, WASHINGTON, DC**

Dr. STEUERLE. Thank you, Mr. Chairman, Mr. Baucus, and members of the committee. I have had the privilege over a number of years to serve members on both sides of the aisle in addressing Social Security and tax issues, and am indeed honored to be here again to try to help you today.

I should indicate right up front that my testimony is largely driven by one major concern: the legacy that our government is about to leave our children is really a government whose almost sole purpose is to finance our consumption in retirement.

There is little left in the budget for other items if we continue the pressure of Social Security and the other programs for the elderly as to the share of the budget that they are going to take.

At the same time, I believe it is possible to build a Social Security system that would do a better job than even current law at removing poverty among the elderly—measured by relative living standards, I should indicate—and serving the majority of the population when they are truly old.

Now, much of my testimony, as requested, deals with our increasing inability to protect the young, the very old, and the vulnerable when Social Security essentially morphs into a middle-aged retirement system, which is what it has become.

Let us begin by defining lifetime benefits as the value at age 65 of Social Security and Medicare benefits as if they were in a 401(k) account. In today's dollars, lifetime Social Security benefits for an average income couple—that is a couple making about \$50,000 combined—is about \$400,000. That figure is up from about \$195,000 in 1960, and it rises to over a half a million another 25 years from now.

If you add in lifetime Medicare benefits, a couple retiring in about 25 years is scheduled to get total lifetime benefits—in constant dollars, discounted (I am not cheating with inflation)—of over \$1 million. We cannot provide benefit packages of this size and encourage people to retire for the last third of their adult lives without significantly affecting—in fact, dramatically affecting—the services that could be provided by government to children and to working families. We simply cannot.

Let me try another lens on these numbers. Close to one-third of the adult population is scheduled in another 2½ decades to be on Social Security. That does not count people on other welfare systems or other people that need support by government. People, today, already retire for about the last third of their adult lives.

Now, this issue is not just one related to the benefits under Social Security, but of the amount of years people retire and the extent to which they drop out of the workforce, reduce national income, and reduce revenues available to government.

If people retired today for the same number of years as they did when Social Security was young—that is, in 1940—they would be retiring about age 74 today. Go out another 40 or 50 years in the future, they would be retiring at about age 78.

What that means is that, by constantly increasing benefits to people who are essentially middle-aged retirees, we reduce the share of benefits that can be doled out to the truly elderly, as measured by life expectancy. I show this in some graphs in my testimony.

Meanwhile, because people retire for so long, the revenues for the rest of the government decline, affecting everything else. I will come back to this revenue picture because it affects the reform options.

Now, believe it or not, I feel there is tremendous opportunity in all of this. People in their late 50s, 60s, and even 70s have now become the largest under-utilized pool of human resources in the U.S. economy. They represent for the labor force, in the first half of the 21st century, largely what women did for the last half of the 20th century.

It is a tremendous pool of human resources if we can figure out how to make use of it. I again point out, if they work, they increase national income, they increase the revenues not just for Social Security, but for everything else.

Now, restoring Social Security to an old-age, and not a middle-aged retirement program can be done partly by increasing retirement ages.

But I also point out some related moves that we can make. For instance, we could adjust benefits so they go more to those who are truly older. That is, we could ratchet benefits to give more in old age and a little less to those who retire when they still have 15, 20, or more years of life expectancy.

These changes progressively move benefits to later ages when people have less ability to work. When they have lower income. And what is very important, when they are less likely to have a spouse around to help them when they have impairments.

By the way, these types of changes put the labor force incentives at the right level, that is, up front when people could adjust, as opposed to other benefit adjustments that affect people when they are older and cannot make adjustments easily. And, I point out again, they can increase revenues.

Now, admittedly, some groups have shorter-than-average life expectancies. But attempting to address their needs by granting many of us—and I am including the people in this room in the audience and myself—a 20th, a 21st, and 22nd year of benefits because of our life expectancy—if we are healthy, that is what we are granted—that is, in many ways, the ultimate form of trickle-down theory.

In effect, I do not think I am protecting the poor by making sure that I get this 22nd year of benefit. But to make an adjustment for those who are poor and have shorter life expectancies, I do favor a good minimum benefit.

If we are going to increase retirement ages, let us back it up with a good minimum benefit so those who have shorter-than-expected life expectancies actually get an improvement in benefits as well.

That is, they do not need to bear the brunt of an increase in retirement age.

Now, one question that often arises when I raise these issues about retirement age—when I talk about Social Security becoming a middle-age retirement system, and Social Security providing an increasing share of benefits every year to those further and further from date of death—is whether people can actually work longer.

In my testimony, I provide three pieces of evidence which I will quickly summarize. First, older Americans over age 55 have been reporting—this is their own reporting—improved health over time. Today, among those even 65 to 74, less than a quarter report that they are in either poor or fair health.

Second, there is strong empirical evidence that the physical demands of jobs have been declining over time. Finally, until recently, the labor force participation of those with similar life expectancies has fallen dramatically over time.

For instance, those age 65, when Social Security was young, had about 16 years of life expectancy. When Social Security was first established, over 85 percent of people with that type of life expectancy worked. Today, it is less than 40 percent. It is hard to believe that, as physical demands have been declining, people have become less capable of working.

Now, in my testimony, I also suggest, as a measure of budget reform and not just Social Security reform, that some rules should be adopted to back up whatever reform we do so that the system would remain in balance over the long run. For instance, persistent projected deficits could automatically lead to a gradual increase in the retirement age or to a reduction in the rate of benefits for middle- and higher-earning workers.

In conclusion, our current Social Security system increasingly favors middle-aged retirement. As a consequence, it reduces the share of Social Security resources for those who are truly elderly. That is an arithmetic fact. There is no doubt that if you provide more and more benefits further and further from death, then smaller shares go to those who are closer to death.

Because of the way our budget is working, the share of revenues remaining for programs for children and working families will decline, as I say, and they will be left with almost nothing if we project our budgets out into the near future.

A reformed system, I believe, can reduce poverty rates, adjusted for living standards over time, while providing many others among the truly old a lifetime benefit that is as good or better than most generations have received in the past.

Thank you.

The CHAIRMAN. Thank you, Dr. Steuerle.

[The prepared statement of Dr. Steuerle appears in the appendix.]

The CHAIRMAN. Now, Mr. Ross?

**STATEMENT OF STANFORD G. ROSS, FORMER COMMISSIONER  
OF THE SOCIAL SECURITY ADMINISTRATION, WASHINGTON,  
DC**

Mr. ROSS. Thank you. Mr. Chairman, Senator Baucus, members of the committee, I am very pleased to have the opportunity to be

here today and to give my views on how to handle the Social Security solvency problem.

I am going to address this based on the charter that this hearing has, which is, how do you achieve financial solvency? This is obviously a challenge, but I do not think it is a crisis.

We have handled problems like this before, and in some ways it is less of a crisis than it was in 1983 when there was a real threat that the checks would not go out. We have time, so we can measure the response and phase it in in a way that does not involve abrupt changes.

The most important thing in approaching Social Security is that it has to be done on a broadly bipartisan basis. Nobody wants to be advocating revenue enhancements or benefit adjustments. Indeed, the less you have to do, the better.

That is why, historically, the way to go about this is to try to develop a package of incremental changes with relatively small effects. That is what I would urge on the committee today. I have attached to my testimony an illustrative package of incremental changes that I think could get us there.

Now, the first thing you have to do is to get your hands around the size of the problem. Here, I do not think the committee is well served by having a very broad range for its target. The SSA Office of the Actuary, based on the 2005 Trustee Reports, has that deficit at 1.92 percent of payroll.

As I understand the CBO numbers—I have not had time to really get into the ones presented today, but I have looked at the ones that were presented previously—a comparable figure is about 1.05 percent of payroll. That is quite a big discrepancy.

I think it is necessary for these two offices to get together and to help policy makers by presenting a common projection, or at least a clear explanation of what the differences are. Then people can make a decision and you can establish a target for the changes you are obviously going to have to make.

In this regard, for the rest of my statement today and my testimony, I have assumed we will use the SSA Office of the Actuary's 1.92 percent, and I have assumed we will use their test for solvency, which is to achieve a balance over a 75-year projection period, plus make sure that at the end there is stable or rising balances so that you do not drop off the cliff and have to have this discussion rapidly again.

I think their test works. I think some of the other things that have been mentioned, such as doing projections on an infinite horizon, which would raise that deficit target to 3.6 percent of payroll, are not helpful. They may be helpful for some purposes, but for this purpose we have a tradition on how you go about this, and I think that is the way to go at it.

Now, just to get something out of the way, adding an individual account system in would make it more difficult to solve this problem. We do not have a comprehensive actuarial study of the President's plan, but it appears that it would increase that 1.92 percent deficit by about 0.6 percent. That is a big hurdle.

I am going to assume for the balance of my testimony that we can focus on achieving financial solvency and we can do it by an incremental package of changes.

Now, traditionally, this package has had roughly an equal measure of revenue enhancements and benefit adjustments. I think if people, on a bipartisan basis, get together and talk about it, that is ultimately where they will get.

That is where they have gotten every other time that this problem has been approached in the 70-year history of the program, and I do not think you need to reinvent the wheel. I think you just need to do it currently; adjust to current circumstances.

On the revenue enhancement side, there are two fairly obvious changes. One is to restore the covered earnings to 90 percent. It has drifted down to 83 percent because of the greater dispersion of earnings in the society, the rich getting richer and the poor getting poorer, and also because there are more non-cash benefits.

I think the 90-percent standard that was used in 1983 is a good one. I think you can get back there incrementally. It produces 0.75 percent of payroll, which is almost 40 percent of the deficit target that you need to cover.

I similarly think that you can subject Social Security benefits to tax in a manner similar to private pensions. I think if you do this, it is sound because the tax revenues recycle through the trust funds to pay more benefits. It is a very good device, far better than approaching it through changing the indexing.

The indexing, as Senator Grassley well articulated, evolved after a great deal of study and turmoil. We finally got to a system that is stable. Economists and others can argue the pros and cons of indexing, but we have a system where you basically rely on wages until you set the initial benefit, and then prices, once you are in retirement status, to keep up the purchasing power. I think that system basically works.

As I will indicate below, a possible benefit adjustment is to make the CPI formula more accurate. There has been more study and you can make better assumptions about consumer behavior, and that actually would improve the deficit by 0.35 percent.

But before I leave the revenue enhancements, I also think what Senator Baucus said is very important. We ought to collect all the payroll taxes that are legally required to be paid. This is a huge item.

We have a \$350 billion annual tax gap, and at least \$50 to \$60 billion of that is in payroll taxes. We can collect some of that. In fact, the country used to do a better job of that.

There are no miracles about how you do it. You give the IRS more money for enforcement, and they conduct more examinations. You give taxpayers a better indication of what they are required to do, and better taxpayer service to help them. I am sure these last two witnesses will be very articulate about it.

I feel strongly about that, because I started my career in Washington in 1961 under President Kennedy. I came here as a young person to work on the first modern tax reform, and I really believe in the need to have a tax system with integrity, and I think we can get there.

Now, on the benefit adjustment side, besides making the CPI more accurate, I would increase the number of years to calculate benefits from 35 to 40. That is entirely in line with having an initial benefit formula that takes account of an entire lifetime of work.

I would hope we would not need to make other changes in the initial benefit formula, but, if we do, that is a far better way to go at it than other ways.

I would also, on the retirement age, begin with what I think is fairly obvious. We now have legislated a normal retirement age of 67. I think we ought to eliminate the hiatus in reaching it and we ought to phase it in more promptly, not wait 11 years before we ratchet it up again. We can then see where we are at.

It may well be that we need to increase the retirement age in the future to deal with some of these longer-term issues that Dr. Steuerle and others are talking about, and that should certainly be studied. But this is an obvious change to get to the 1.92 percent.

Similarly, there are other things about benefits that could be improved. The spousal benefit, which gives an automatic 50 percent based on the higher earner's wage history, can be seen as discriminating against lower-earner spouses and working spouses.

I think we can revamp that. I think we can work on adding a better minimum benefit and make other changes in the benefit structure that would improve the efficiency and effectiveness of the system and get the balance of what we would need to have a 50/50 package.

Finally, I would say that it is important to give the Social Security Administration, like the IRS, some additional resources to do a better job. There are long lines in Social Security offices. The 800 telephone number service is not adequate. Applicants for disability benefits can wait years to get a determination.

Short-changing the administrators of what is a very good system does not serve the American people well. They deserve better, and that should be part of any package of legislative changes to improve solvency.

Finally, I would close by saying, because we all read the newspapers, if in the present political climate it is difficult to directly achieve the broad bipartisanship that is needed, I would recommend you consider a commission along the lines of the 1983 commission that included members of Congress, or the recent 9/11 Commission that took another approach.

I have to say that I do not think the President's commission was helpful. It did not have the right mandate. The mandate required an inclusion of individual accounts.

I think a clear mandate that says, achieve solvency, give us an agreed state of facts and a good set of options, would help the Congress get on with it. These matters we are talking about, even small or incremental changes, much less larger changes such as Dr. Steuerle has talked about, are quite complicated.

You need an expert staff to do work in a dispassionate atmosphere, and the Congress could then be presented, if it had about a year to work and it got appointed quickly, by next summer, with a good report that might allow Congress to reach agreement.

At any rate, I welcome the opportunity to be here. I have appeared before this committee many times. I respect the bipartisanship that this committee has always reflected. If there is any way I can be helpful to you to get to that consensus, I am prepared to do it.

Thank you, Senators.

The CHAIRMAN. Thank you for your thoughtful comments.  
[The prepared statement of Mr. Ross appears in the appendix.]  
The CHAIRMAN. Mr. Yin?

**STATEMENT OF GEORGE K. YIN, CHIEF OF STAFF,  
JOINT COMMITTEE ON TAXATION, WASHINGTON, DC**

Mr. YIN. Thank you, Mr. Chairman, Senator Baucus, members of the committee. Thank you for inviting me to testify today.

I have been asked to present to the committee various tax legislative changes that could be adopted to improve the solvency of the Social Security system.

I set forth in my written testimony possible expansions to the employment tax base, as well as certain options relating to the employment tax rate and cap, and have included very preliminary revenue estimates of most of the options presented.

I encourage the committee to consider changes that would make the employment tax base more comprehensive before contemplating possible employment tax rate changes or an increase in the employment tax cap.

Most of the tax base options were described in the recent Joint Committee staff report on options to improve tax compliance and reform tax expenditures, and are worthwhile changes apart from any effort to improve Social Security solvency.

Moreover, distortions created by existing exceptions to the tax base, such as growth in the use of non-cash compensation and certain forms of business entities, may be exacerbated if the exceptions are permitted to continue with an increase in tax rates and/or the tax cap.

Let me briefly describe for you four possible employment tax base changes. First, the employment tax treatment of partners, S corporation shareholders, and owners of limited liability companies needs to be clarified and reformed.

Under current law, each of those taxpayers may face different employment tax liabilities, even though the services they provide on behalf of their businesses are the same. As a result, the choice of business form may be motivated more by a desire to avoid or reduce employment tax liabilities rather than by non-tax considerations.

The conceptual problem is that the income of these taxpayers may represent a mix of economic returns for labor and capital. If employment taxes are to apply only to their labor income, then labor income must be properly segregated from capital income.

Under the proposal of the Joint Committee staff report, the distributive share of income of these taxpayers is generally made subject to SECA tax. Exceptions, however, are provided for certain types of capital income and in situations where the taxpayer does not materially participate in the underlying business.

The staff option thus attempts to measure the labor income and the resulting employment tax liabilities of these taxpayers in the same way, and similarly to that of sole proprietors.

This more uniform treatment improves the fairness of the tax law and increases tax neutrality by reducing the importance of employment tax differences in a taxpayer's choice of business form.

A second option is to address the problem of under-reporting of compensation income by sole proprietors and others not subject to wage withholding. IRS studies have consistently shown this problem to be the single largest contributor to the tax gap.

The staff report includes a proposal to impose withholding on certain government payments for goods and services that are not currently subject to withholding. Because such payments represent a significant part of the economy, the proposal can be expected to improve compliance to a significant extent without burdening any private-sector payors.

The proposal thus attempts to balance the goals of improving compliance and not creating undue administrative burdens. This proposal could be expected to increase income tax and employment tax revenues, both by collecting some tax from the transaction and by stimulating voluntary reporting and payment of tax apart from any amounts actually withheld.

A third option is to provide consistent FICA treatment of salary-reduction amounts. Under current law, contributions made to tax-favored retirement plans by salary reduction, such as contributions to 401(k) plans, including the Federal Thrift Savings plan, are wages for FICA purposes.

However, salary-reduction amounts used to provide other non-retirement benefits, such as health and dependent care benefits, are excluded from wages for FICA purposes. The staff report includes a proposal to treat all salary-reduction amounts as wages for FICA purposes.

Legislative history indicates that salary-reduction retirement contributions are included in the FICA tax base in order to avoid undermining that base and making the Social Security system partially elective. This rationale for the FICA treatment of retirement plan contributions applies equally to salary-reduction amounts used to provide other benefits.

One effect of this staff proposal is to provide more consistent FICA treatment of amounts paid by employees to purchase non-retirement benefits, regardless of whether the benefits are provided through or outside an employer-sponsored plan.

Finally, the proposal to impose FICA taxes on all benefits provided through salary reduction could be expanded to apply to all non-retirement employee benefits. Such a proposal would also provide consistent FICA tax treatment with respect to employer-provided and non-employer-provided benefits.

A variety of issues would need to be addressed under such a proposal that do not arise under the staff option. For example, valuation issues do not arise under the staff option because the amount of salary reduction is known, but valuation issues may arise with respect to benefits not provided on a salary-reduction basis.

I have set forth in my written testimony a number of other possible employment tax base changes, and have also included for discussion purposes several options that would change the employment tax cap or rates.

I would be pleased to answer any questions about any of the options outlined. The staff looks forward to working with the committee in developing proposals for you, and we appreciate very much the opportunity to testify.

The CHAIRMAN. Thank you, Mr. Yin.  
[The prepared statement of Mr. Yin appears in the appendix.]  
The CHAIRMAN. Now, Mr. George?

**STATEMENT OF HON. RUSSELL GEORGE, OFFICE OF THE  
TREASURY, INSPECTOR GENERAL FOR TAX ADMINISTRATION,  
U.S. DEPARTMENT OF THE TREASURY, WASHINGTON,  
DC**

Mr. GEORGE. Thank you. Chairman Grassley, Senator Baucus, members of the committee, thank you for the opportunity to discuss a report that my office is releasing today that has implications for achieving sustainable solvency for Social Security. Mr. Yin's testimony briefly addressed the topic.

The objective of our report was to determine whether the existing laws, tax regulations, and IRS policies and practices ensure fairness in the administration of self-employment tax laws for similarly situated taxpayers. We compared the employment tax liabilities of sole proprietors to the employment tax liabilities of single-shareholder S corporations. Our report found that employment tax inequities exist between sole proprietorships and single-shareholder S corporations.

These inequities have historical underpinnings. In 1958, Congress established Subchapter S of the Internal Revenue Code, which enabled small businesses, including sole proprietorships, to form corporations owned by 10 or fewer shareholders.

Electing S corporation status exempts profits from corporation taxation and allows profits to pass through to the shareholders. Shareholders are then responsible for paying individual income taxes on the profits received. In addition, shareholders who actively operate the businesses are subject to employment taxes on the compensation received for their services.

The IRS developed its methodology for dealing with the employment taxes of S corporations in 1959. This methodology does not properly address how today's S corporations are structured because the 1959 methodology is based on the assumption that S corporations will have multiple shareholders or owners. In a multiple-shareholder environment, a consensus of shareholders typically set the salary of the business operator at a level reflecting the market value of the operator's services.

However, in Tax Year 2000, 78.9 percent of all S corporations were either fully owned by a single shareholder, or more than 50-percent owned by a single shareholder. Therefore, in nearly 80 percent of S corporations, the individual who owns the business determines the amount of the salary paid to the shareholder operating the business.

The decision by the single shareholder of an S corporation of what amount to pay himself or herself in salary has tax consequences. A lower salary results in lower employment taxes and higher profits. In comparison, sole proprietorships are treated much differently for the purposes of employment taxes.

Employment taxes are authorized by the Federal Insurance Contributions Act, or FICA, and the Self-Employment Contributions Act, or SECA. FICA applies to S corporations and SECA applies to sole proprietors. Under FICA, S corporations are required to with-

hold taxes from the wages of employees with matching amounts paid by the employers. In comparison, under SECA, sole proprietors must pay taxes on profits from the operation of their businesses.

The self-employment tax law treats all profits, except for an amount equal to the employer portion of FICA, as if they were wages. As a result, the sole proprietor pays the equivalent of both the employer and employee portion of FICA on business profits.

The different tax treatment has caused the S corporation form of ownership to become a multibillion-dollar employment tax loophole for single-shareholder businesses. For example, as shown in this first chart, in Tax Year 2000, the owners of 36,000 single-shareholder S corporations received no salaries at all from their corporations, even though the operating profits of each of these corporations exceeded \$100,000. This resulted in employment taxes not being paid on \$13.2 billion in profits.

A 2001 Tax Court case provides a textbook example of the type of S corporation shareholder I am referring to. A veterinarian was conducting business as, and was the sole shareholder in, his S corporation. His corporation produced over \$400,000 in total profits over 3 years, yet during these 3 years he declared no salary for himself, despite the fact that his corporation's sole source of income was from his services. In court, the IRS prevailed. The Tax Court agreed that the corporation's profits should be subject to employment taxes.

Now, determining what is reasonable compensation to pay a business officer is complex and subjective. The IRS must sometimes engage in litigation. Since the IRS is forced to address the issue of reasonable officer compensation on a case-by-case basis, many owners of S corporations have apparently determined that saving employment taxes by minimizing salaries is worth the risk of an IRS examination.

As shown in the next chart, owners of single-shareholder S corporations vary widely in the amount of salary they give themselves. As you can see, at the top of the chart, many are willing to set their salaries at zero dollars to maximize their employment tax savings.

Furthermore, the owners of single-shareholder S corporations have been setting their salaries at a decreasing percentage of corporate profits in the past several years.

As shown in this third chart, in Tax Year 1994, these shareholders paid themselves salaries subject to employment taxes equal to 47.1 percent of their profits. This percentage fell to 41.5 percent by Tax Year 2001. In comparison, sole proprietors pay employment taxes on all of their operating profits.

The employment tax consequences of these single-shareholder S corporations paying themselves little or no salaries are in the billions of dollars. My final chart compares the actual FICA taxation of single-owner S corporations to the theoretical SECA taxation that would have been paid if these profits were taxed as a sole proprietorship. In Tax Year 2000 alone, S corporations paid \$5.7 billion less in employment taxes than would have been paid if the taxpayers were sole proprietorships.

Billions of dollars in Social Security and Medicare taxes are being avoided by single-shareholder and majority-owned S corporations. Trends indicate that the employment tax base is eroding. In fact, advising small businesses to save on employment taxes by forming S corporations has become a cottage industry. A search of the Internet yields many sites that advises entrepreneurs that they can save thousands of dollars a year in employment taxes simply by incorporating.

The Joint Committee on Taxation shares my concern about the employment tax treatment of pass-through entities such as S corporations, and has, as you heard, recommended changes to their taxation. Additionally, the Joint Committee outlined five general principles for improving compliance and reducing the tax gap in testimony before this committee last month. The employment tax treatment of owners of pass-through entities was included as one example of how compliance is hampered when tax outcomes are dependent on difficult factual determinations.

Mr. Chairman, members of the committee, I appreciate the opportunity to discuss this important issue. I look forward to working with the IRS to identify and recommend solutions to the problem, and would be happy to answer any questions you have at the appropriate time.

[The prepared statement of Mr. George appears in the appendix.]

The CHAIRMAN. Thank you.

We will take 5-minute turns. One of my colleagues is concerned about everybody sticking with 5 minutes, so I will try to set a good example.

Senator LOTT. The witnesses did not.

The CHAIRMAN. But I thought I was very lenient and liberal with the witnesses because we have a big problem of understanding these issues, and these folks have studied it for a long period of time for us, and I thought they needed that time.

Dr. Holtz-Eakin, when people compare Social Security benefits over time, they often compare them in terms of replacement rates, that is, a person's benefit relative to his or her own wages.

As you point out in your testimony, relative to any given level of income, replacement rates are rising under current law. In other words, someone who makes \$1,500 a month in the future will collect a higher benefit than someone who makes \$1,500 today.

Do you believe that the American public is aware of the fact that, under current law, people who earn the same income and pay the same taxes will receive higher benefits in the future than they do today?

Dr. HOLTZ-EAKIN. Well, Senator, I have no idea what the American public is aware of, but I do not think that there has been a full depiction of the distributional consequences of even the current system, and that is one aspect of it.

The CHAIRMAN. All right.

And given the fact that we are unwilling to raise our own taxes to pay for higher benefits today, do you believe it is reasonable to expect future workers to pay higher taxes to support higher benefits in the future?

Dr. HOLTZ-EAKIN. I think that the broad lesson of the various studies, not just the CBO's, but others', is that it is appropriate to

restructure the system now to give people time to anticipate what changes they will have, and what the system will look like in the future, and that the current structure is unsustainable. Just waiting and adding a piecemeal fix in the future is probably not desirable.

The CHAIRMAN. Also to you, it is often suggested that switching from wage-indexing to price-indexing would reduce replacement rates. However, as you pointed out in your testimony, there are two different ways to implement price-indexing. So, I would like to have you give us further explanation of the two different approaches and how they affect replacement rates over time.

Dr. HOLTZ-EAKIN. I believe you are referring to just the pure price-indexing versus the progressive price-indexing?

The CHAIRMAN. Yes.

Dr. HOLTZ-EAKIN. I wanted to make sure. There are, in fact, more than two. There are an infinite number of ways to do this. But the pure price-indexing is the simplest to explain because it is just an across-the-board change in the way the initial benefits are indexed over time. They make sure that, in the future, the initial benefit gets the same purchasing power that the benefit has right now, and that is preserved through the pure price-indexing.

The progressive price-indexing provides that same real benefit at the top end of the income distribution, it provides a rising real benefit at the bottom end of the income distribution, and it provides a mixture in between. One could provide that mixture in any number of ways. It would depend on the details of any particular proposal.

The CHAIRMAN. All right.

Also to you. It has been suggested that switching from wage-indexing to price-indexing would reduce benefits for future retirees. In Figure 9 of your testimony, you compared lifetime benefits under each of the options to the benefits that are scheduled under current law.

However, Social Security cannot pay the benefits scheduled under current law. If you compare all future retirees to the cohort born in the years 1940 to 1949, is it not true that all future cohorts would receive as much or more on a lifetime basis?

Dr. HOLTZ-EAKIN. Under current law, to give you a flavor of this—that includes the exhaustion of the trust funds going forward—it will be the case that lifetime benefits will rise.

The highest household earnings quintile in the 1940 cohort will get, on average, \$243,000, the 1970 cohort, \$303,000 in lifetime benefits, all in the same inflation-adjusted dollars, and the 2000 cohort, even facing the trust fund exhaustion, would get \$363,000 in lifetime benefits.

The CHAIRMAN. All right.

Dr. Steuerle, some people say that Congress should not raise the retirement age. You referred to this, about whether or not people, particularly doing manual labor throughout their career, are too worn out to keep working.

But in your testimony, you point out that in the 1940s and 1950s, the average worker did not start collecting Social Security until they were 68. Is there any reason to believe that people were

healthier and jobs were easier in the 1940s and 1950s than they are today?

Dr. STEUERLE. Mr. Grassley, in my testimony I provide several pieces of evidence on this point. People report that they are healthier. The studies we have done on physical demands of jobs show that they have declined.

If you look closely at the decline in labor force participation of workers having a similar life expectancy, what you find is a great deal of it occurred during that very time period when early retirement benefits were made available in Social Security, and Medicare was made available. Once that point was hit, all of a sudden you had this very rapid fall-off in labor force participation rates of, say, workers with 16 years of life expectancy.

Before that, it remained relatively constant, even from about 1940 to 1960. All of these pieces of evidence—and this is empirical evidence, done in a nonpartisan way—indicate to me that there is no evidence at all that people are less capable of work today than in the past. In fact, they are probably more capable.

Can I just add one additional item on this replacement rate issue? The replacement rate has, for a long time, been based on the notion of what the elderly get versus the non-elderly. That is sort of the purpose behind it.

Even if we use replacement rates—and I am not sure that they are the best measures—if we take into account that people are living longer, their lifetime replacement rates have been going up. If you go far enough in the future, they are still going up, even with the increase in the retirement age.

The reason is, if you think about a lifetime benefit package providing more and more years of benefits relative to lifetime earnings, it has gone up significantly over time. If you go far enough into the future, it will start going back up again.

The CHAIRMAN. All right.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

I was struck by what I regard as Mr. Ross's very thoughtful approach. That is, this is not a crisis. We do have some time, but we should not procrastinate. We should start now, but we do have some time. This means that we have the opportunity to come up with some thought-through, thoughtful solutions here.

Almost by definition, it has to be bipartisan, as was the case in 1983. That was solved because, finally, at the end, when that commission could not reach agreement, a very high official of the White House called a couple of Democrats in the commission and said, hey, let us make a deal here.

We Republicans will agree with tax increases if you Democrats agree to benefit cuts. They said, you bet. Therefore, the President and the Congress, Republicans and Democrats, shook hands and joined together to find a thoughtful, incremental, bipartisan solution.

I also think it does not make sense to propose fairly drastic changes in the current Social Security system, as would be the case with some of the proposals that we have heard about lately, and one is private accounts. That is drastic, and it makes the problem worse, not better. Worse.

If we are to solve the solvency problem of Social Security, we should certainly not take actions which make the problem worse, not better. We are here to solve it, not make it worse.

Second, I am a little concerned about some of the proposals on the table today, and some of the testimony today, which is focused so much on benefit cuts only or to some degree on some revenue rise.

But the thrust of the President's proposals, and Mr. Pozen's proposals, which are basically the President's proposals, as has been suggested here with these various new options asked of the CBO to provide, are essentially benefit cuts, and pretty drastic. Very drastic.

We all know Social Security is in trouble. We all know that lifetime earnings is increasing. We all know the demographics. That is a given. The real question is, what is the solution here?

So I just want to get a couple of points out here, and would like some of the witnesses to tell us, just for the record, the facts. Forget the politics, just the facts. Is it true, or is it not true, that the addition of carve-out private accounts makes the solvency problem more difficult to solve?

Dr. Holtz-Eakin?

Dr. HOLTZ-EAKIN. Viewed in isolation, with no other change to the account, taking—

Senator BAUCUS. The answer is yes?

Dr. HOLTZ-EAKIN. Yes.

Senator BAUCUS. Thank you.

Dr. Steuerle?

Dr. STEUERLE. That is correct.

Senator BAUCUS. You agree, it makes it worse?

Dr. STEUERLE. I agree.

Senator BAUCUS. All right.

Mr. Ross?

Mr. ROSS. Yes, it makes it far worse, because the package that you will need to get it in balance just has to be hugely greater.

Senator BAUCUS. Mr. Yin?

Mr. YIN. I do not have a view on that.

Senator BAUCUS. Whoa. Whoa. I am not going to let you off that way. Mr. Yin, your analytic, Joint Tax, honest answer. I mean, you are a very smart man. You are particularly smart with figures. You have looked at Social Security solvency.

Mr. YIN. Senator, I read the papers and so forth, but I have not analyzed it from a professional standpoint the way the other three gentlemen who have just responded have, so I would be reluctant to give you a professional judgment on that.

Senator BAUCUS. What is your personal judgment? Your personal judgment. Your honest, personal opinion.

Mr. YIN. I really do not think that would be appropriate to share with the committee.

Senator BAUCUS. Does it help solve the problem?

Mr. YIN. Well, I do not know. I just have not examined it from a professional standpoint.

Senator BAUCUS. I am astounded, Mr. Yin, at that response.

Mr. George?

Mr. GEORGE. Thank you. Senator, my report was limited especially to the employment tax issue. I am an attorney, not an economist. I really do not have an answer.

Senator BAUCUS. You are also a good soldier.

I would like also to ask some of you, why do we not look at some of these other options that have been suggested here? For example, let me ask Dr. Holtz-Eakin about those that Mr. George is applying, namely, SECA and FICA treatment.

Well, let us go back to proprietorships versus S corporations. It looks like many S corporations, particularly controlled by one shareholder, or two, are avoiding salaries to avoid employment taxes. Why not correct that as part of the solution?

Dr. HOLTZ-EAKIN. I do not see any reason why one could not analyze all the options.

Senator BAUCUS. But on the face of it, in your mind, is that something worth exploring?

Dr. HOLTZ-EAKIN. I think, certainly, from what I have heard—and I have heard only what I have heard sitting at the table—it is important to remember that if one were to bring those into the earnings base, there would be benefits paid on them as well, unless some change was made.

Senator BAUCUS. Right.

Dr. HOLTZ-EAKIN. So, do both sides of the equation. Do not just look at the tax side, look at the earnings side and make sure the benefits are included in that calculation.

Also, think about the tax policy objectives. You do not want to bring too much capital income into the base, because then you will make the same mistake in the other direction and drive people to reorganize on the basis of tax consideration.

So, certainly it merits consideration, it merits thoughtful consideration, and we would be happy to work with you, and especially the Joint Committee, if that is someplace you would like to go.

We did include some tax options in our menu. The menu, I really want to emphasize, is a work in progress. It is not comprehensive. It was meant to provide stylized components of the kinds of things that are important to consider. If this is something like that, I would be happy to work with you on that.

Senator BAUCUS. What is your reaction to some of the thoughts that Mr. Yin suggested?

Dr. HOLTZ-EAKIN. In terms of equalizing the treatment of S corporations and sole proprietorships?

Senator BAUCUS. Yes. Right.

Dr. HOLTZ-EAKIN. That was the heart of my comments. I think you do have to calculate the benefits as well. It is not just taxes. The timing will be different, but both will be on the table. I think that it is important for the committee to remember that there are both financial considerations and tax policy considerations. If you have a hard time drawing the line—

Senator BAUCUS. What about salary reductions?

Dr. HOLTZ-EAKIN. I am sorry?

Senator BAUCUS. Salary reductions.

Dr. HOLTZ-EAKIN. I have not looked at that. I would be happy to work with you.

Senator BAUCUS. All right. Well, my time has expired. But I would just urge us to look at a much broader range of options and not just as this panel is primarily suggesting, at least your end of the panel, benefit cuts only.

Thank you.

The CHAIRMAN. Senator Crapo?

Senator CRAPO. Thank you very much, Mr. Chairman.

I would like to ask any member of the panel who would like to respond to this to discuss with me for a minute just what exactly does happen at the time when the trust fund runs out of money, whether it is 2042, or 2052, or wherever that happens.

Let us take the 2042 projection, which I think then has a 26 percent cut. How is that cut administered? Does every person receiving Social Security at that time get a 26 percent cut in whatever benefit level they are receiving? Maybe, Mr. Ross.

Mr. ROSS. Yes. I am a lawyer and I have served as a public trustee. My understanding of the law is that the benefits cannot be paid unless there is money in the trust fund at the beginning of the month to pay full benefits. You cannot make a partial benefit payment.

Some of the notion that there is an automatic cut to pay whatever you have, 80 percent, I do not think is in accord with the law.

In the 70-year history of the program, the Congress has never allowed that Armageddon to arise, that you get to the beginning of the month and there is not enough money to pay the benefits. I do not think Congress will ever allow that to happen. There has to be legislation in advance that tells the Treasury what to do.

Senator CRAPO. Well, but assuming that Congress does not do that, assuming the current law, are you saying that at the time when there is not enough money in the fund to pay the benefits due that month, that you pay zero?

Mr. ROSS. You pay zero.

Senator CRAPO. So everyone's benefits are reduced to zero?

Mr. ROSS. Then the benefit does not go out. That is why, in 1983, it was that gun to the head that got people to agreement. The Congress has to act. This is not a matter of administrative discretion. There is nothing in the law that says anything but pay the full benefit, and if you do not have the money to do it, then you pay zero.

Senator CRAPO. Does anybody else on the panel have a different perspective on what the law says?

Dr. STEUERLE. I do not disagree with Mr. Ross. The month you do not have the money, you would not pay. It may be the next month you do.

Senator CRAPO. So you might be paying in alternative months.

Dr. STEUERLE. So over the course of the year you might end up paying 75 or 80 percent. Stan, do you agree with that?

Mr. ROSS. We have never encountered that. I think the lawyers who are advising the Secretary of the Treasury would have to stay up quite a few nights to come up with this kind of alternating payment approach.

I think they would probably be up here pleading with the Congress to give them clear direction, because as far as the public is concerned, if you think of some poor beneficiary out there who is

waiting for that check, they would much rather know that if they are not going to get it, what they are going to get. They get it every month as their—

Senator CRAPO. I certainly agree with that, Mr. Ross. In fact, that is what we are here trying to do, trying to forestall that occurrence.

Mr. ROSS. That is why I do not think it is possible to realistically think that Congress will not act eventually to give a clear answer to what you pay when Armageddon is approaching.

Senator CRAPO. I certainly hope you are right, and I hope we act sooner than later.

Dr. Holtz-Eakin, I would like to talk to you for a minute, because in his testimony Mr. Ross made a very good point, I thought, as I took it. He said we have two very different sets of projections about what is going to happen, and when.

Frankly, the fact that we have two such different projections is making it much more difficult for us to analyze and determine how to address this issue on a policy basis.

Why? I mean, I understand the fact that they are different because of the assumptions that are being made. But why do we have such vastly different assumptions?

Dr. HOLTZ-EAKIN. This is a really important question, so let me respond in two different areas. First is substance and process with the two different projections.

First, on the substance, these are, in my view, two very high-quality projections about the future of the finances of the Social Security that make different choices, in some cases, depending on the objectives.

In our case, the CBO's are intended to build up the 10-year projections, which provide the baseline for budget projections, so they must marry up well with those.

They are intended to be cohesive in providing the ability to analyze Social Security from the perspective of not just program finances, but the budgetary implications and all the interactions there, as well as economic impacts at the level of beneficiaries and at the level of aggregate economic performance. We grow faster or slower under different circumstances. So, our choices are driven by that. The Social Security Administration makes different choices.

My own view is that, given the standards of science in this area, these are essentially the same policy projections. I know numerically they differ, but there are uncertainties that prevail in the future. Both projections tell the same story to the Congress.

Importantly, with a few notable exceptions, most of the reforms that have been considered look the same regardless of which baseline you start with, so the changes you make come out about the same.

As a matter of process, I can speak only for CBO. We will continue to provide both. We will do the CBO projections for those interested. We can provide our mimic of the SSA, and are happy to. It is up to Congress. There is statutory guidance on what to do in the 10-year baseline, but there is not beyond that. So, we are going to work with you.

What you are going to have to worry about is what the Chairman mentioned at the outset, which is making sure that an analysis

provided by us or the Social Security Administration marries up well with an evaluation of the financial condition at the end of that. If the CBO baseline is used and the trustees agree that that constitutes a fix, that is fine. If you use the trustees', you have an automatic guarantee that marries up well with theirs.

Now, I know that is a longer answer than anyone deserves on this, but it comes up again and again and again. I think it is an important issue to be resolved so that, going forward, the discussion is about the issues and not about the numbers.

Senator CRAPO. Well, thank you.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. Well, that is a good segue into my questions because I have the same kinds of questions. I thank Senator Crapo for asking that, because I think that is going to be increasingly part of this debate.

Let me just say, I have grave doubts—very serious doubts—about the underlying assumptions made by everybody here. Let me show why.

Under the assumptions by the Social Security actuaries and by CBO, they are saying economic growth over the next 75 years is going to be 1.9 percent a year. That is an incredibly pessimistic forecast. Looking at the past 75 years, economic growth has been 3.4 percent.

What happens if future economic growth was the same as past economic growth? Well, here is what happens. Eighty percent of this problem goes away. Eighty percent of the shortfall disappears if we just have the same economic growth in the next 75 years that we have had in the past 75 years.

Now, this is more than an academic question about projections, because I have gone back now and looked at what the actuaries told us in 1994. My colleagues, in 1994, told us there was 36 years of solvency left. That is what their report says.

In 2005, guess what? They tell us there are 36 years of solvency left. How can it be? Eleven years ago, there were 36 years of solvency left. Eleven years later, there are 36 years of solvency left. It is because they completely underestimated economic growth.

Now, does this mean we do not have a problem? No. I wish it did. But we do have a problem. We have a big problem. I just think we have been asking, frankly, the wrong questions.

The problem we have, to me, is a budget problem. The budget problem we have is, first of all, that the shortfall in Medicare is 7 times the shortfall in Social Security. This is much less prone to these kinds of missed assumptions than is Social Security, at least as I look at it, because it is driven by two things that are very likely to continue.

One is the fact the baby boomers are going to retire. They have been born, they are out there. Also, medical inflation is running far ahead of other inflation, and technical changes make that likely to continue.

Second, we have record budget deficits now before the baby boomers retire. Third, the President is proposing a tax policy that has the cost of the tax cuts explode at the very time the baby boomers retire. This is totally disconnected from any reality.

In addition, Social Security, those bonds that we talk about which are backed by the full faith and credit of the United States, they are real assets, but they have to be redeemed out of current income. This is missing from this discussion.

Yes, it is true Social Security is solvent long into the future. It is also true that it is solvent because of assets that are held in the trust fund, and those assets are a call on the general revenues of the United States.

When those bonds come due, they must be paid for out of current income, so you connect the dots for the American people: massive shortfall in Medicare; record budget deficits now; baby boomers retiring; Social Security has to be redeemed out of current income, and we are headed for a train wreck. We are headed for a train wreck.

But I must say, I think the assumptions on Social Security are extremely pessimistic, and very likely to be just wrong. I would hope that we would go back to a much more fundamental question of the problems and challenges facing us, which are, to my way of thinking, a budget crisis. All of these elements contribute to it.

I would ask, Mr. Ross, when I look back on this message from the trustees, you are one of the signatories of this message to us back in 1994, saying we had 36 years of solvency left at the time. Do you recall that?

Mr. ROSS. Yes.

Senator CONRAD. And now they are telling us that there are 36 years of solvency left. Why do you think there was this significant variance from what actually occurred?

Mr. ROSS. Because the projections are made on the basis of assumptions and methodologies. The assumptions change as experience changes. There are trends, there are fads in the climate of opinion among economists, demographers, and others who are called on. That is why we have safeguards in the system to do this annually. Periodically, we do technical panels to check these assumptions.

One of the last ones, I was chairman of the bipartisan, independent Social Security Advisory Board, and my colleague here, Dr. Steuerle, was the chairman of the technical panel. We had a broad range of people in, and we looked at it. But you cannot lock it up for all time. You have to look at it freshly.

Senator CONRAD. I agree with you. I think, given what the Congress is trying to do now because of where the President has placed this solvency issue on the agenda, I think it should be looked at fresh and made sure that the assumptions and methods are as good as we can get, and that the policymakers have the best information possible to make decisions.

Let me just say, given the variance between what is projected and what has happened, the idea of trying to do this over an infinite time horizon leaves me cold. It just strikes me as so utterly unrealistic.

The CHAIRMAN. Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Mr. George, I am very troubled by the fact that a substantial number of extremely wealthy people are not contributing their share on the Social Security matter. They are what I call the Social

Security scofflaws. That is what they are, Social Security scofflaws. I think Senator Baucus was dead right, that you ought to go after them first.

My question to you with respect to this substantial under-reporting is, do you believe that enforcement is all that needs to be done in order to get this revenue, or is it also a matter of changes in the statute to provide new tools? Let us start there.

Mr. GEORGE. Let me preface my response, Senator, by saying when you call them "scofflaws," you must remember that the law currently allows people to make this election.

Senator WYDEN. There is no question about that, and I understand that. I still think, when you talk about this, we are talking about a substantial number of very wealthy people. I want to know whether you need a statutory change or whether you can do this by enforcement.

Mr. GEORGE. Well, the basis of this is an Internal Revenue Service revenue ruling dating back to the 1950s. We believe that statutory change is required to make the changes that would allow for the elimination of this problem, sir.

Senator WYDEN. Good.

Mr. Yin? Yes.

Mr. YIN. If I could just comment. There is an enforcement issue because, under current law, the requirement is based on reasonable compensation. So, it is a question of, to what extent is that being well enforced? But that is a very difficult line to enforce.

So, I would concur with Mr. George that, as our testimony suggested, that statutory changes are needed not just in the subchapter S area, but in all of the other areas, the limited liability companies and partnerships as well.

Senator WYDEN. That is what I mean. I think this is a very broad kind of area, and we are going to want to follow this up with you.

A question for you, Dr. Holtz-Eakin. Thank you for your cooperation. You have always assisted me and been very responsive. When you brought up the question of surpluses essentially now and into the future, you did not talk about how the continued use of the Social Security surplus for other programs in government contributes to this problem.

Can you tell us what your judgment would be on this? Because this is what I think most bothers the American people. I mean, they understand the demographics. We are going to have more older people retiring, and fewer younger people.

Yet, I think when they look back at the history from 1983, they see that the Social Security surplus then was continually used for other matters. So, I would like you to lay out for us just what, in effect, the abuse of the surplus has done with respect to solvency.

Dr. HOLTZ-EAKIN. Well, I think it is central to examine this issue in the broader budgetary context. CBO has always tried to present that so it is clear that you can see the interactions where current surpluses in payroll taxes and excessive benefits are showing up in the unified budget.

In the future, any 75-year balance plan requires that they be delivered back, with interest, in the presence of these other budgetary

demands, Medicare and Medicaid, in particular. So I think that perspective is central.

Number two, the economic question is whether we have, in the process of the past 20 years, with payroll taxes and excessive benefits, managed to take that surplus and, in an economic sense, save it by raising national saving, accumulating more in the way of technologies and physical capital so the pie is bigger, so we can pay for everything in the future, public and private. That is the question. I would say, on balance, the answer is no.

The government budget, with focus on current consumption and borrowing to finance current consumption at the moment, mitigates against that. So going forward, we have to raise national saving. That is part of Social Security. It is also part of everything else. We have not done that in the past.

Senator WYDEN. And you have to level with the American people. That is what happened in 1983. The American people were told that this was going to pre-fund the baby boomers, and it did not happen. Yes, sir?

Dr. STEUERLE. Senator Wyden, when I give talks to the public—and I agree with you, the public has to be engaged in this issue—I often make an analogy to a household.

Suppose as a household I spent \$100,000 and made \$80,000. Then on the side, I decided to borrow not just \$20,000 to finance my consumption, but \$30,000, and put that extra \$10,000 into an account.

Then suppose I pass those debts and that account on to my children, and I tell my children, you owe me a great deal of money because of the amount that I have in the account. That is sort of the equivalent.

The amount we have put in these Social Security trust fund accounts, which is relatively modest relative to the liabilities, is being passed along to our children, along with a huge amount of liabilities, not just from the current deficits we are running, but from all the promises that we have made to ourselves.

Senator WYDEN. Mr. Chairman, thank you.

The CHAIRMAN. You bet.

Senator Lott?

Senator LOTT. Thank you very much, Mr. Chairman. Thank you to all the panel members for being here. I wish we had more time to ask questions, but all of your testimony has been quite interesting.

Dr. Holtz-Eakin, first of all, is it accurate that the numbers do not add up when you factor in the fact that we are living longer, the fact that we have the baby boomers—my generation—coming, and the fact we have huge benefit increases? We are just not going to be able to continue on this path without there being a tremendous shortfall, right?

Dr. HOLTZ-EAKIN. Benefits, paid and promised, exceed dedicated revenues as far as the eye can see.

Senator LOTT. It is real simple. And you know the American people have that figured out. They understand it, really. They are not sure what we should do about it and they are not quite sure exactly when it is essential that action be taken, but they understand that the numbers do not add up.

And by the way, I think most elderly people like my mother, at 92 years old, almost, is more worried about what is going to be there for her children and grandchildren than she is about the fact that her situation is going to be protected and she is not going to have her benefits cut.

Is it also not just very clear, Dr. Holtz-Eakin, that the sooner we begin to address this problem, the easier it really will be? Not that it will be easy, but you have a longer time to lead into it. You can take your actions where they have gradual effects rather than, boom, a shock, and with each passing year, we get about another, what, half a trillion dollar hit in solving the problem. Are those statements accurate?

Dr. HOLTZ-EAKIN. Moving sooner is better from the point of view of beneficiaries, certainly. Simply resolving the uncertainty would be a good thing. Being able to make plans for the new system would be a good thing.

Moving sooner is better from the government budget perspective under the assumption that any additional surpluses you accumulate actually turn out to be economic surpluses. If they are dissipated, then you have not really gained by moving.

Senator LOTT. Right.

Let me ask you this, too. We have this Washington-speak, which is so disingenuous, in my opinion. And I say “we” because we all are guilty of it. But only in Washington, if you control the rate of growth of benefits, is that considered a cut, even though your benefits are still going up.

So the fact of the matter is, if we go with an honest CPI—because what we have now is not honest—or if we convert to using prices instead of wages, that benefits will not go up as fast, but will still go up. Is that accurate?

Dr. HOLTZ-EAKIN. You can certainly run the system with different price indexes that will provide higher real benefits than people receive today.

Senator LOTT. Yes. Yes.

Dr. Steuerle, I thank you for having the courage, at least, to address this question of, thank goodness, we are living longer and we are living better, but it is creating a huge problem for Social Security. So what do we do? You have been over it, but let me get it real simple.

Do we go automatically to a straight age increase? Or what about this idea, that you index it to longevity? If we wind up living now, where the average age becomes 80, that it would automatically go up, giving us political cover, because we can say we did not have any hands on the steering wheel, it just automatically happened. What about that concept?

Dr. STEUERLE. Well, Senator, if the system had been indexed for longevity from the beginning and we had the current tax rate, we would not be sitting here. We would be in substantial surplus and we would not have an issue.

Senator LOTT. No question about it.

Dr. STEUERLE. The complication with starting indexing right now, is that, by itself, it is not enough to restore solvency. The main reason is we delayed so long. It was not just the baby boomers coming along, which actually gave us a reprieve.

It is the decline in the birth rate that started in the 1920s—that temporarily stopped when the baby boomers came along, and then came along again—that forces us, in some sense, in one generation, to make changes we would normally make over three generations.

So to some extent, items like the increase in the normal retirement age from 65 to 67, and adjustments like that, have to take place in addition. Just indexing, by itself, is not enough.

Senator LOTT. But if we indexed and went back to prices instead of wages—and I was in Congress when these changes were made. In fact, I voted against them. But I understood why we converted to wages, because we thought it would be better for the system at the time. Then things flipped and now it has created the problem.

But if we just did those two things, all other things being considered equal—and I know it is saying too much—we would have the problem resolved and money left over, right?

Dr. STEUERLE. I am not sure how those two add up. I would have to check with Doug here. But I want to say, even if we had no solvency problem, the fact that we retire people—and I tried to make this very clear—for longer and longer still gives us an argument for increasing the retirement age.

Senator LOTT. No question about it.

Dr. STEUERLE. The reason is that smaller and smaller shares of benefits are going to the people who are truly old and in need.

Senator LOTT. I have been stunned that my classmates, some of them, have been retired since they were 58.

Dr. STEUERLE. If you give the benefits back to the old, I am saying—

Senator LOTT. Why? I think you ought to work until you cannot work any longer, personally. But the thing about it here is, we can solve this problem, I believe, by addressing the age question and controlling the rate of growth of the benefits. We do not need tax increases. I think one of the cruelest taxes of all is the payroll tax, because it hits that working man and woman so hard.

But let me just address my last question to you, Mr. George. Is it not a fact that the people that get hit the hardest by Social Security taxes are small business men and women? No wonder they try to get over subchapter S. They are trying to get out of being hit twice as hard as the average worker. Is that not true?

Mr. GEORGE. I agree, sir.

Senator LOTT. All right.

Well, I just think that my colleagues on the other side of the aisle think the solution is just raising taxes. I think that, as the only solution, is not acceptable, so I hope we can work with that viewpoint in mind.

Thank you, Mr. Chairman.

The CHAIRMAN. The Senator from Arkansas.

Senator LINCOLN. Thank you, Mr. Chairman.

I do not know where that last one came from, Senator Lott, about raising taxes, but we are all looking for some plausible solutions of how we maintain a program that has meant so much to so many.

So, Mr. Chairman, we thank you for bringing us together once again to discuss this really important issue.

I want to thank all of our panelists. Our great Nation is faced with a number of economic challenges, including, but definitely not limited to, Social Security. I think you all have made some inferences in some of your comments, but I strongly believe that this debate is about more than Social Security.

It is certainly about the budget and the economy. It is about Medicare and Medicaid. Certainly, the issue that the President and others want to continue to borrow from the Social Security trust fund for things other than Social Security, we have all been guilty of that.

Some of the most recent have been very large tax cuts. It is wrong, and the people of this country know it. The debate is really about setting priorities. My priorities are to ensure that Arkansas and its people, and other people across this country, have the retirement security that they need to live their lives with dignity, and certainly minimize the burden to future generations.

So, we applaud you all for being here and working with us, and I applaud the Chairman and Senator Baucus. I certainly look forward to working with him towards the end of finding those answers.

Dr. Holtz-Eakin, the Congressional Budget Office has put many options on the table to address Social Security solvency, and these options would generate a large amount of money for Social Security, certainly a program that will be able to pay 75 to 80 percent of its promised benefits beyond 2041 or 2052, wherever you want to choose.

On the other hand, the Medicare trust fund is predicted to be exhausted by 2020, over 20 years earlier than Social Security, which is, I think, clearly a more imminent concern for us, is this financial crisis for Medicare.

Has CBO put any options on the table to address Medicare?

Dr. HOLTZ-EAKIN. We do not have a comparable menu for the Medicare program—

Senator LINCOLN. Do you intend to get one together?

Dr. HOLTZ-EAKIN. [Continuing]. That reflects both our focus on Social Security at the moment, Senator. But also, there is a big difference between the two programs in the research community. Social Security is a program that is, by and large, well understood. The menu that has been provided by the research community is much deeper and broader. The program is simpler in the sense that it is just money. I do not mean that in a cynical fashion.

Senator LINCOLN. I think you are right, though. It is much easier.

Dr. HOLTZ-EAKIN. The source of the problem in Medicare is rising health care costs in excess of the growth of the economy as a whole, and that is less well understood.

The diagnosis is not as clear. Is it higher quality, in some cases? Administrative costs? Over-utilization? All those aspects. As a result, the menu of solutions is thinner. We do not have the same consensus. We certainly look forward to working with you on it, but it is a harder problem.

Senator LINCOLN. Good. Well, I hope we will, because I do think that, because it is a harder problem and the solutions are not as easy to come up with, and the problem that exists with Medicare

comes sooner than Social Security, that we will focus some time on that. Because, clearly, if those solutions are harder to find and it is a much more intricate problem, we are going to have to devote some serious time to it. I hope that we will.

I guess I would like to address this to Dr. Holtz-Eakin as well, but any of you others can answer. I think some of you already have. It, a little bit, has to do with the assumptions that Senator Conrad brought up.

But there was a recent article in *Business Week* that asserts that Social Security's problems are economic and not demographic. As we know, in 1983 the Social Security Commission knew that the Nation was going to be faced with some big demographic changes, but the article says that there were two things that the commission could not anticipate: the growth of average U.S. wages slowing down and the income inequality rising very sharply.

I guess, Dr. Holtz-Eakin, you did not really answer that question in terms of these assumptions on economic growth that we are assuming in much of what is being talked about in Social Security being much larger than what they have historically been.

Dr. HOLTZ-EAKIN. Let me say a couple of words about that. The pieces that you need to do a projection of this sort are numbers of bodies and how much income you get per body, the productivity of those workers. The dominant difference between the past and the future is simply the growth in the number of bodies.

Over the past 30 years, there has been a growth of 60 percent in the covered workers in the system. Going forward, there is going to be a growth of 15 percent, and that is due to the demographics.

So, the total growth rate of the economy is driven, to a great extent, by demographics. Much of that is baked in the cake. The piece that is not, is immigration, the source of real population growth going forward, which will depend, in many cases, on policy and economic development. So, first, is bodies.

The second is productivity of those workers and what they will earn in wages as a result. Part of that is just pure technology. I do not think anyone is projecting a diminishment of the U.S. technological prowess going forward, so that part I would expect to remain quite strong. We have that in our projections.

The next piece is national saving and the accumulation of the resources to train people, buy factories, give them better equipment. That is a wild card, the degree to which we save as a Nation and equip those workers.

Given that none of this is for sure, what we have tried to do is display the range of uncertainty in our projections, to be quite honest about it. The hope is to give that to you, not as an acknowledgment of our broad incompetence as a profession, but instead to indicate those situations where solutions are robust to the way things actually pan out versus those where they are very knife-edge, and steer away from those that rely heavily on particular assumptions.

Senator LINCOLN. Absolutely.

Dr. STEUERLE. Senator Lincoln, as Stan Ross mentioned, I chaired a technical panel where we examined these issues. And one of the points that was hard to make, but we tried to make very strongly, was that when policy makers address Social Security,

they do not just need to target some very long-run average benefit or average actuarial balance. They can also target the uncertainty.

The reason Social Security and Medicare, as you mention, are very different from other programs we have as a Federal Government is that these are the primary ones where we promise increased levels of benefits for 75, 100, 200 years in the future.

It is not that we could not also project educational spending for 200 years in the future. But you do not as a Congress index teachers' salaries for wages, and you do not have them automatically grow. So what happens is, we put only a select group of programs on automatic pilot.

With automatic growth, we do not give other programs a level playing field. We put other programs at a severe disadvantage in the budget process. Then we force our estimators to estimate the cost of our promises.

Well, they will not estimate educational spending 20 years from now because it is not in the budget. But we do have promises for Social Security 20 years from now.

The point I am trying to make is that we can reduce that uncertainty. For instance, if we are not certain about how long people are going to live, we can index for life expectancy.

If we are not certain about the economy, we can index so that the system does certain things as the economy changes. If economic growth provides additional reprieve to the system, then we can increase the rate of benefit growth. In effect, we can actually target uncertainties in designing policy.

That is what we have not done in Social Security, and to a larger extent, Medicare. I just want you to remember that you can actually target reducing the uncertainty so that future economic and demographic changes do not constantly force you back to the table.

Senator LINCOLN. I want to make sure I am clear on what I am hearing you say. You are indicating that it is less economics and more demographics.

Dr. STEUERLE. Well, it is more demographics, as Doug Holtz-Eakin just mentioned, because the drop in workers-to-retirees from 3 for 1 to 2 for 1 is a demographic push, it is not economics.

Economics can help you a little bit in terms of economic growth. The problem is, economic growth increases benefits in a wage-indexed system, so when you get more economic growth, you also get more benefits.

Senator LINCOLN. Is that same demographic, though, not very prevalent in the fact that you are seeing a sharp increase or a rise in income inequality? That kind of highlights that demographic that you are talking about.

Dr. STEUERLE. You could target the income inequality as well by saying that you are going to have the wage base adjust over time so it covers 90 percent of the wages; if the income becomes more unequal, then you are going to have the wage base still grow. You can also target the issues that the two gentlemen at the end of the table mentioned in terms of the wage base.

There are two reasons why the wage base in Social Security has become worse over time. One is increasing inequality, and one is because we have a constant increase in the share of compensations

not subject to tax. We could change those laws so those things did not occur.

What I am indicating is that, in almost all these areas of uncertainty, we can actually target them. It would leave the system more in balance over time. Even if you left it at the current level of 1 percent or 2 percent of taxable payroll, 75-year actuarial imbalance, we could reduce the uncertainty around that. If you want a target of zero percent, we can reduce the uncertainty by dealing with all these issues.

Senator LINCOLN. It just seems like there is more involved there than what we have actually been targeting as it is.

A couple of last questions.

The CHAIRMAN. Your time is up.

Senator LINCOLN. Oh. Are we going to have another round?

The CHAIRMAN. Yes.

Senator LINCOLN. All right.

The CHAIRMAN. Sure. We will give you all the time you want. Senator Baucus will give you all the time you want. [Laughter.]

I want to focus on an argument that I sometimes hear, and we have heard it this morning, about solving the Social Security financial problems by closing the tax gap and dedicating those revenues to Social Security.

I am very interested in closing the tax gap. Senator Baucus and I have worked together on the tax gap. Last year, Mr. Yin, we wrote you a letter asking you to report to this committee on ways to reduce the tax gap. You reported back to us with a variety of proposals.

Some of those proposals were aimed at improving tax compliance, some really were aimed more at what I call tax reform rather than the tax gap, in the truest sense of the word. Many of the proposals could be very, very controversial with members, even on both sides of the aisle.

But in any event, let us just assume that all of those proposals were enacted in law. How much revenue would that bring into the Federal Government? You can use the 10-year figure, but an average annual figure, I think, is a good basis, too.

Mr. YIN. Mr. Chairman, I do not remember the figure offhand. Bear in mind that we did not estimate the package of proposals together, so that we did not measure the potential interaction. We estimated each of the independent items in isolation from all of the others, so it would not necessarily be the sum total.

The CHAIRMAN. It would not be the \$300 billion over 10 years?

Mr. YIN. I believe the sum total was somewhere in the range of \$400 billion over 10 years, but that is correct, sir.

The CHAIRMAN. So \$30 billion a year, which would go a long ways from closing this problem we have with Social Security. I mean, it would fall way short of the problem we have identified here today.

Mr. YIN. Well, of course, it depends on what your target is. I mean, from where I come from, that is still not chump change. But I understand what you are saying, sir.

The CHAIRMAN. All right.

I would like to follow up with you, and to expand a little bit on this question and drill down some of the specific proposals, because

too many members seem to think the tax gap is like ripe fruit on the ground waiting to be just picked up.

You mentioned one of these would be repealing the mortgage interest deduction on home interest loans. Another one would be subjecting State and local workers to the Medicare tax. One would be subjecting workers to use cafeteria and other fringe benefits to pay the payroll tax on those, or allowing offshore activities of U.S. companies to be exempt from tax.

I know that members on both sides of the aisle, Republicans and Democrats, who would have serious concerns with those proposals. I am sure that many here would not endorse them. Most of the other proposals in the Joint Committee report generate similar controversy.

Just focusing on these four proposals, however, how much of the number—well, you could not remember, but I thought it was in the neighborhood of \$300 billion—is reflected in these four proposals, which would be the total revenue impact of all the proposals in your report, minus these four?

Mr. YIN. Again, Senator, I do not have that number. And probably just to clarify, the proposal on mortgage interest only related to home equity loans. It did not affect your mortgage on your principal residence, but it did involve a curtailment of the deduction on home equity borrowing.

The CHAIRMAN. I did not realize that we have a vote right now.

Senator BAUCUS. Mr. Chairman, I will just defer to our colleague from Arkansas, if she wants to ask some questions. I have no more questions.

Senator LINCOLN. I just had two quick questions.

The CHAIRMAN. Do not forget to go vote.

Senator LINCOLN. No, no. I will not. I will not.

The CHAIRMAN. Because I am not going to be here to remind you.

Senator LINCOLN. All right. Well, thank you. Thank you, Mr. Chairman. I will be very brief.

The CHAIRMAN. Thank you all very much on the panel.

Senator BAUCUS. This was a thoughtful discussion. Mr. Chairman, I thank you for allowing the witnesses to go beyond the customary 5-minute rule, because I think it helped us think this through a little more thoughtfully, and I thank you very much. You all have been very good, and I appreciate it.

Senator LINCOLN. I agree with those two gentlemen.

Dr. Steuerle, you mentioned about allowing people in the workforce longer, allowing them to continue their productivity. We had a great hearing on that in the Aging Committee, a lot of good testimony about that. But has anybody studied what that does to unemployment?

Dr. STEUERLE. Most economists do not accept the notion that if an elderly person works longer, he or she in some sense is taking away a job from a younger person. The reason is fairly simple. If I work longer and I make \$50,000, it means I am producing \$50,000 for the economy and I am \$50,000 richer. If I go out and I buy other goods and services, then I create a demand for \$50,000 of goods and services that somebody else must produce.

Senator LINCOLN. So there has been a universal understanding or something that this is not going to have an impact?

Dr. STEUERLE. In the Depression, there was an argument that Social Security needed to retire people early so they could create jobs for young people. I should say, by the way, we did not get out of the Depression until we got into World War II.

Senator LINCOLN. All right.

I think, Mr. Yin and Mr. George, I just have to believe that increasing enforcement can happen without increasing taxpayer education. So, only focusing on the enforcement, I feel like, is somewhat short-sighted and can result really in our taxpayers not getting the services and the information that they need.

Do you agree that if in fact what we need to do is to crack down and make sure that we are doing a better job in the collection of that, that we also need to do a better job in educating, getting them the tools that they need to comply with increased enforcement?

Mr. YIN. Senator Lincoln, I think that better taxpayer information is always useful, but I think the laws do have something to do with it. If the laws are written in a way that does not require a lot of taxpayer information or a lot of taxpayer compliance obligations, that facilitates the collection task for everybody. It facilitates for the taxpayer, it facilitates for the enforcement agency.

So I think that the design of the law is a critical piece of the puzzle. That said, obviously, given the laws that we have, taxpayer information is certainly an important issue.

Senator LINCOLN. Thanks, Mr. Yin.

Mr. GEORGE. Senator, I agree with what Mr. Yin stated. Once again, what the report that we issued today deals with is a legal loophole in the tax law. So whether or not education is the issue here, I am not sure, but overall, of course, an informed populace is a better populace in terms of making decisions.

Senator LINCOLN. That is the largest complaint we usually get up here, is that we just willy-nilly enact laws and then we forget they have to be implemented on a local level. Without an educational component, oftentimes there is a lot that is not there.

There are a couple of minutes left, and I want to make sure the Chairman knows I do not miss the vote.

Thank you all very much for participating. We are grateful for your expertise and sharing that with us. Thank you.

I will adjourn the committee.

[Whereupon, at 12:12 p.m., the hearing was concluded.]



# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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### PREPARED STATEMENT OF HON. RUSSELL GEORGE

Chairman Grassley, Senator Baucus, Members of the Committee, thank you for the opportunity to discuss a report that my office is releasing today regarding the Internal Revenue Service's administration of certain employment tax laws.

The objective of our report was to determine whether the existing tax laws, tax regulations, and IRS policies and practices ensure fairness in the administration of self-employment tax laws for similarly situated taxpayers. We compared the employment tax liabilities of sole proprietors to the employment tax liabilities of single-shareholder S corporations. Our report found that employment tax inequities exist between sole proprietorships and single-shareholder S corporations.

These inequities have historical underpinnings. In 1958, Congress established Subchapter S of the Internal Revenue Code, which enabled small businesses, including sole proprietorships, to form corporations owned by 10 or fewer shareholders. Electing S corporation status exempts profits from corporate taxation and allows profits to "pass through" to the shareholders. Shareholders are then responsible for paying individual income taxes on the profits received. In addition, shareholders who actively operate the business are subject to employment taxes on the compensation received for their services.

The IRS developed its methodology for dealing with the employment taxes of S corporations in 1959. This methodology does not properly address how today's S corporations are structured because the 1959 methodology is based on the assumption that S corporations will have multiple shareholders or owners. In a multiple shareholder environment, a consensus of shareholders typically set the salary of the business operator at a level reflecting the market value of the operator's services.

However, in Tax Year 2000, 78.9 percent of all S corporations were either fully owned by a single shareholder, or more than 50 percent owned by a single shareholder. Therefore, in nearly 80 percent of S corporations, the individual who owns the business determines the amount of the salary paid to the shareholder operating the business.

The decision by the single shareholder of an S corporation of what amount to pay himself or herself in salary has tax consequences. A lower salary results in lower employment taxes and higher profits. In comparison, sole proprietorships are treated much differently for the purposes of employment taxes.

Employment taxes are authorized by the Federal Insurance Contributions Act, or FICA, and the Self-Employment Contributions Act, or SECA. FICA applies to S corporations, and SECA applies to sole proprietors. Under FICA, S corporations are required to withhold taxes from the wages of employees, with matching amounts paid by the employers. In comparison, under SECA, sole proprietors must pay taxes on profits from the operation of their businesses. The self-employment tax law treats all profits (except for an amount equal to the employer portion of FICA) as if they were wages. As a result, the sole proprietor pays the equivalent of both the employer and employee portions of FICA on business profits.

The different tax treatment has caused the S corporation form of ownership to become a multibillion dollar employment tax loophole for single-shareholder businesses. For example, as shown in this first chart, in Tax Year 2000, the owners of 36,000 single-shareholder S corporations received no salaries at all from their corporations, even though the operating profits of each of these corporations exceeded \$100,000. This resulted in employment taxes not being paid on \$13.2 billion in profits.

A 2001 tax court case provides a textbook example of the type of S corporation shareholder I am referring to. A veterinarian was the sole shareholder in his S corporation. His corporation produced over \$400,000 in total profits over three years. Yet, during these three years, he declared no salary for himself, despite the fact that his corporation's sole source of income was from his services. In court, the IRS prevailed. The tax court agreed that the corporation's profits should be subject to employment taxes.

Determining what is reasonable compensation to pay a business officer is complex and subjective, and the IRS must sometimes engage in litigation. Since the IRS is forced to address the issue of reasonable officer compensation on a case-by-case basis, many owners of S corporations have apparently determined that saving employment taxes by minimizing salaries is worth the risk of an IRS examination. As shown in the next chart, single-shareholder S corporations vary widely in the amount of salary they give themselves. At the top of the chart, you can see that many are willing to set their salaries at \$0 to maximize their employment tax savings.

Furthermore, the owners of single-shareholder S corporations have been setting their salaries at a decreasing percentage of corporate profits in the past several years. As shown in this third chart, in Tax Year 1994, these shareholders paid themselves salaries subject to employment taxes equal to 47.1 percent of their profits. This percentage fell to 41.5 percent by Tax Year 2001. In comparison, sole proprietors pay employment taxes on all their operating profits.

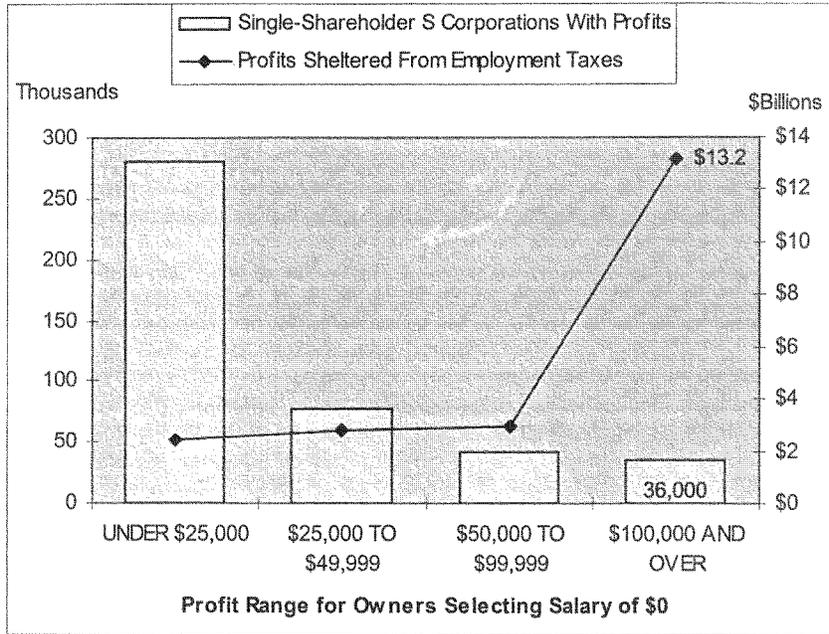
The employment tax consequences of these single-shareholder S corporations paying themselves little or no salaries are in the billions of dollars. My final chart compares the actual FICA taxation of single-owner S corporations to the theoretical SECA taxation that would have been paid if these profits were taxed as a sole proprietorship. In Tax Year 2000 alone, S corporations paid \$5.7 billion less in employment taxes than would have been paid if the taxpayers were sole proprietors.

Billions of dollars in Social Security and Medicare taxes are being avoided by single-shareholder and majority-owned S corporations. Trends indicate that the employment tax base is eroding. In fact, advising small businesses to save on employment taxes by forming S corporations has become a cottage industry. A search of the Internet yields many sites that advise entrepreneurs that they can save thousands of dollars a year in employment taxes simply by incorporating.

The Joint Committee on Taxation shares my concern about the employment tax treatment of pass-through entities – such as S corporations – and has recommended changes to their taxation. Additionally, the Joint Committee outlined five general principles for improving compliance and reducing the tax gap in testimony before this Committee last month. The employment tax treatment of owners of pass-through entities was included as one example of how compliance is hampered when tax outcomes are dependent on difficult factual determinations.

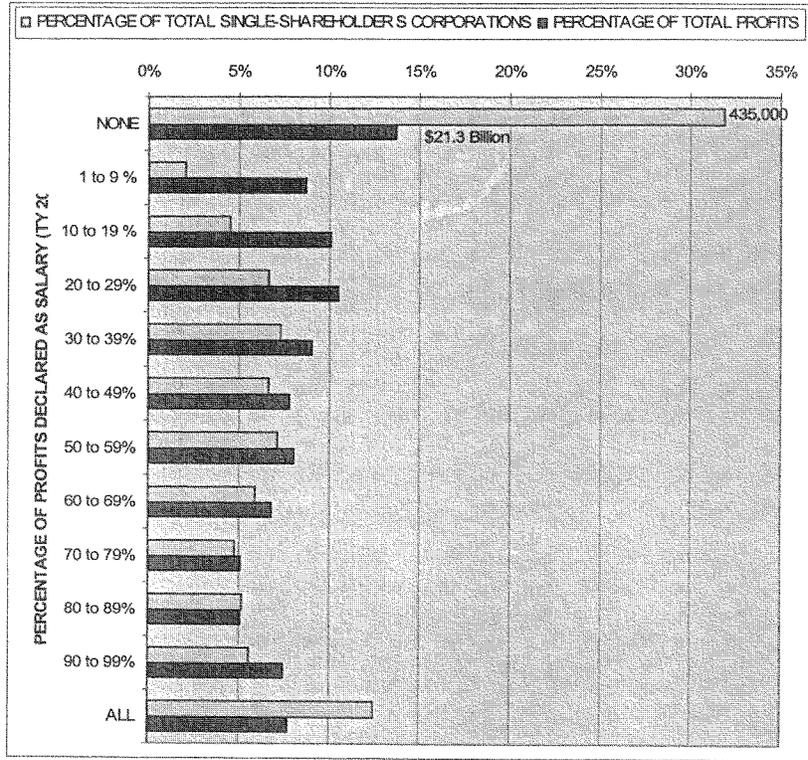
Mr. Chairman and members of the committee, I appreciate the opportunity to discuss this important issue. I look forward to working with the IRS to identify and recommend solutions to this problem. I will be happy to answer any questions you have at the appropriate time.

**Operating Profits of S Corporations That Paid No Salaries to the Sole Owners (Tax Year 2000)**



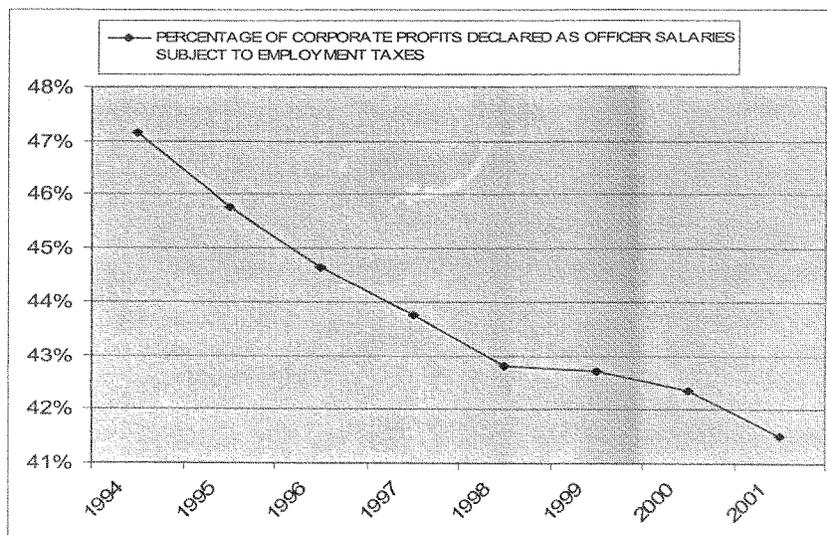
Source: TIGTA analysis of IRS Master File Data. These data reflect the impact of S corporation spousal ownership but not majority ownership.

### Variations in Salaries Selected by Owners of Single-Shareholder S Corporations (Tax Year 2000)



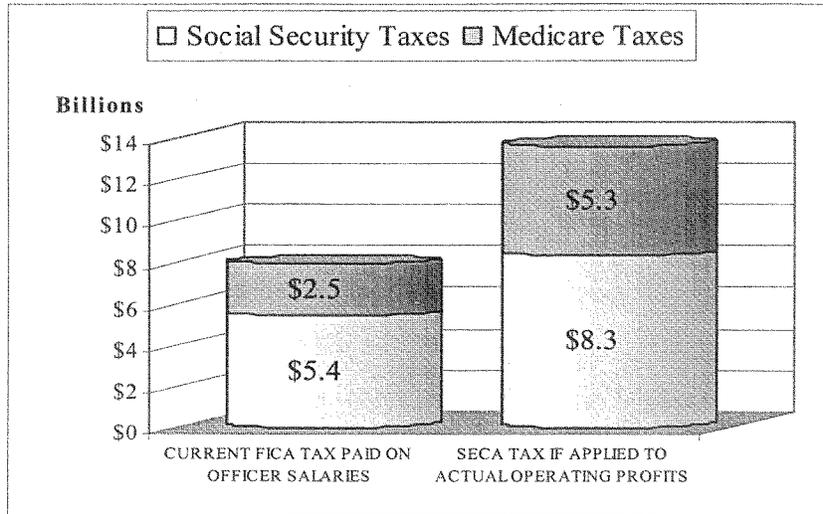
Source: TIGTA analysis of IRS Master File Data. These data reflect the impact of S corporation spousal ownership but not majority ownership.

**Officer Salaries Declared by Single-Shareholder  
S Corporations As a Percentage of Operating Profits  
(Tax Years 1994 – 2001)**



Source: IRS SOI function data.

**Actual FICA Taxation vs. Theoretical SECA Taxation of S Corporations (Tax Year 2000)**



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS Master File data

**Actions Are Needed to Eliminate Inequities in  
the Employment Tax Liabilities of Sole  
Proprietorships and Single-Shareholder  
S Corporations**

**May 2005**

**Reference Number: 2005-30-080**

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INSPECTOR GENERAL  
of TAX  
ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

May 20, 2005

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND  
ENFORCEMENT

*Pamela J. Gardiner*

FROM: Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Actions Are Needed to Eliminate Inequities  
in the Employment Tax Liabilities of Sole Proprietorships and  
Single-Shareholder S Corporations (Audit # 200430022)

This report presents the results of our review of the Internal Revenue Service's (IRS) administration of self-employment tax laws. The overall objective of this review was to determine whether the existing tax laws, tax regulations, and IRS policies and practices ensure fairness in the administration of self-employment tax laws for similarly situated taxpayers.

In summary, inequities exist between the employment tax liabilities of sole proprietors and the employment tax liabilities of the owners of single-owner S corporations.<sup>1</sup> The employment tax methodology applied to S corporations does not properly address the facts and circumstances related to the predominant ownership structure of today's S corporations.<sup>2</sup> This condition is largely the result of Revenue Ruling<sup>3</sup> 59-221<sup>4</sup> issued

<sup>1</sup> In 1958, the Congress established Subchapter S of the Internal Revenue Code (I.R.C.) that enabled small businesses, including sole proprietorships, to form corporations owned by 10 or fewer shareholders. Electing this form of business organization, commonly referred to as an S corporation, exempts the profits from corporate taxation and allows the profits to "pass through" to the shareholders who are then responsible for individual income taxes on the profits.

<sup>2</sup> This report addresses issues similar to those discussed in the Joint Committee on Taxation (JCT) report *Options to Improve Tax Compliance and Reform Tax Expenditures* JCS-02-05 (January 27, 2005). Despite similarities in conclusions and recommendations, this report was developed independently without knowledge of the JCT study.

<sup>3</sup> A Revenue Ruling represents the IRS' official interpretation of the I.R.C. as it applies to a particular set of facts. Revenue Rulings are intended to promote the uniform application of the tax laws and assist taxpayers in attaining maximum voluntary compliance.

<sup>4</sup> 1959-1 C. B. 225; Rev. Rul. 59-221 (January 1959).

by the IRS in 1959 because the 1958 statute that established S corporations in tax law<sup>5</sup> was silent on the employment tax treatment of the corporate profits.

When the Revenue Ruling was issued, no S corporation tax returns had yet been filed, so the IRS based its ruling on assumptions regarding the ownership structure of S corporations. Apparently assuming that a majority of S corporations would involve multiple shareholders, the IRS concluded only shareholders actively operating the business should be subject to employment taxes and only on amounts received for their services. In a multishareholder environment, it would have been reasonable to assume that the salary of the business operator would be set by a consensus of shareholders at a level reflecting the market value of the operator's services.

What apparently was not anticipated was that most S corporations would eventually consist of sole proprietors who chose to incorporate without expanding ownership to include additional shareholders. In Tax Year (TY) 2000, 78.9 percent of all S corporations were either fully owned by a single shareholder (69.4 percent) or more than 50 percent owned by a single shareholder<sup>6</sup> (9.5 percent). Also apparently unanticipated was the fact that, when there is only one shareholder controlling and operating an S corporation, the determination of a salary is unilateral, highly subjective, and influenced by the knowledge that a higher salary will result in higher employment taxes and therefore lower profits.

One of the criteria for judging a tax system is whether similarly situated taxpayers are treated the same. Given equal amounts of income subject to employment taxes, owners of single-shareholder S corporations and sole proprietors are similarly situated for employment tax purposes. However, a fundamental and significant inequity is created between sole proprietors and owners of single-shareholder S corporations by the manner in which taxable income is determined, since sole proprietors pay employment taxes as a percent of all profits, while owners of single-shareholder S corporations pay employment taxes on only the portion of profits they unilaterally select as their salaries.

The 1959 Revenue Ruling that created this inequity has had three major detrimental effects on the tax system. First, the S corporation form of ownership has become a multibillion dollar employment tax shelter<sup>7</sup> for single-owner businesses. In 1959, the maximum potential loss of employment tax revenue from allowing owners of single-shareholder S corporations to select their own salaries would have been only \$8.3 million (\$49.1 million in Calendar Year 2000 dollars). In TY 2000, the cost was \$5.7 billion due to historical increases in employment tax rates and the ability of nearly 80 percent of S corporation owners to minimize their employment taxes by minimizing their salaries.

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<sup>5</sup> Pub. L. No. 85-866, 72 Stat. 1650 (1958).

<sup>6</sup> Majority ownership provides such shareholders with the ability to make unilateral decisions, such as setting officer salaries.

<sup>7</sup> A tax shelter is the way of organizing a business to reduce or eliminate taxes.

Second, Revenue Ruling 59-221, in effect, places the burden on the IRS to prove that the salary chosen by the owner of a single-shareholder S corporation is not "reasonable" (i.e., commensurate with the services the shareholder provided to the S corporation). Dealing with this issue on a case-by-case basis puts a severe strain on the limited resources of the IRS. In TY 2000 alone, 36,000 single-shareholder S corporations with profits of \$100,000 or more passed through total profits of \$13.2 billion to their sole owners without paying any employment taxes. The cost of the IRS resources needed to effectively combat such a large problem on a case-by-case basis would be prohibitive.

Third, trends point to continued erosion of the employment tax base and related reductions in Social Security and Medicare revenues that employment taxes produce. The number of single-shareholder S corporations (as reported on U.S. Income Tax Return for an S Corporation (Form 1120S)) grew from 1,030,716 in TY 1994 to 1,684,861 in TY 2001, a 63.5 percent growth rate. Single-shareholder S corporations accounted for 26.4 percent of the combined profits of sole proprietorships and single-shareholder S corporations in TY 1994 and 36.1 percent in TY 2001. As single-owner business profits shift to the S corporation structure, the amount of salaries selected are steadily declining as a percent of corporate profits. Owners of single-shareholder S corporations paid themselves salaries subject to employment taxes that equaled only 47.1 percent of their profits in TY 1994, which fell to just 41.5 percent by TY 2001. In contrast, unincorporated sole proprietors pay self-employment taxes on all of their profits.<sup>8</sup>

To eliminate the employment tax shelter for most S corporations, increase Social Security and Medicare employment tax revenues by \$30.8 billion and \$30.2 billion respectively between Calendar Years 2006 and 2010, provide for equitable employment tax treatment of taxpayers, and reduce the burden on IRS examination resources, we recommended the IRS Commissioner inform the Assistant Secretary of the Treasury for Tax Policy of the detrimental effects discussed in this report of Revenue Ruling 59-221 that was apparently issued under the historically inaccurate assumption that most S corporations would involve multiple shareholders. The IRS Commissioner should consult with Treasury regarding whether the detrimental effects of Revenue Ruling 59-221 should be reversed through the issuance of new regulations or through the drafting of new legislation, either of which should subject all ordinary operating gains of an S corporation that accrue to a shareholder (including the shareholder's spouse and dependent children) holding more than 50 percent of the stock in the S corporation to employment taxes.

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<sup>8</sup> For purposes of determining employment taxes, the profits of sole proprietorships are calculated as gross income minus expenses and an amount equal to the employer's share of Federal Insurance Contributions Act (FICA) taxes. S corporations also deduct the employer's share of FICA taxes from their income for determining profits.

Management's Response: The Commissioner, Small Business/Self-Employed (SB/SE) Division, disagreed with the report recommendations but agreed there were problems related to compensation paid to S corporation officers and that differences exist between the employment tax liabilities of sole proprietorships and single-shareholder S corporations. The Commissioner, SB/SE Division, did not agree that IRS Revenue Ruling 59-221 was the cause of these problems. In discussions and in management's response, the IRS has expressed its belief that, since it was based upon corporate employment taxation statutes and regulations in effect prior to the creation of S corporations, Revenue Ruling 59-221 confirms that Self-Employment Contributions Act (SECA) taxes do not apply to S corporation shareholders. The IRS believes legislative rather than regulatory changes could help reduce the problems they experience in relation to the employment taxes of single-shareholder S corporations and believes any such legislation should also address possible similar inequities in other types of business structures. However, the IRS also stated that simplifying the assessment of employment taxes, as we recommended, would not be consistent with the underlying principles of employment tax statutes in connection with the performance of services.

Because the Commissioner, SB/SE Division, does not agree the source of the problem was Revenue Ruling 59-221 and believes it is important to consider the problem in the context of other business entities, the Commissioner, SB/SE Division, did not agree with the specific recommendations in this report or with the related outcome measures. Regarding the outcome measures, the Commissioner, SB/SE Division, expressed concerns that the outcome measures did not take into account that some taxpayers may react to the implementation of our recommendations by converting S corporations to other business structures. Concern was also expressed that our outcome measures did not reflect the impact of additional employment taxes that may be paid by owners of single-shareholder S corporations having multiple sources of income subject to employment taxes. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: We disagree with the IRS position that Revenue Ruling 59-221 *confirmed* rather than established that SECA taxes should not apply to single-shareholder S corporations, and we continue to believe the current employment tax inequities are the result of the Revenue Ruling. The historical file for this Revenue Ruling shows the Revenue Ruling was prompted by a 1958 question from a taxpayer regarding whether or not self-employment taxes (applicable to sole proprietors) would apply to the profits of the newly-created S corporations. Rather than addressing the case of a sole proprietor choosing to become a single-shareholder S corporation, the IRS response discussed a multi-shareholder S corporation and concluded that self-employment taxes should not apply to the profits of such S corporations. The IRS applied the concepts supporting this decision to all S corporations, regardless of the number of shareholders, when it issued Revenue Ruling 59-221 in 1959.

We are encouraged the IRS recognizes that changes in tax law may be advisable as it relates to the compensation of owners of single-shareholder S corporations. While we

support the IRS desire to eliminate through such legislation similar employment tax inequities in other business structures, identifying and quantifying such possible additional inequities were beyond the scope of this review. In addition, we do not believe correction of the current inequities discussed in the report should be delayed while a search for possible additional inequities is conducted. Nor do we believe current inequities should continue out of apprehension that an unquantifiable number of taxpayers may change their business structures to pursue new strategies to avoid employment taxes.

In response to IRS concerns related to the possible impact of taxpayers having multiple sources of employment-taxable income, we have reduced our original 5-year estimate of total additional employment tax revenues to \$61 billion. See Appendix IV for additional information. In addition, we have added notes (a) through (c) to Recommendation 2 on page 18 to clarify our position on various uncertainties expressed in IRS management's response.

While we still believe our recommendations are worthwhile, we do not intend to elevate our disagreement concerning them to the Department of the Treasury for resolution.

Copies of this report are also being sent to IRS managers affected by the report. Please contact me at (202) 622-6510 if you have questions or Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (215) 516-2341.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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**Background**

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The Federal Insurance Contributions Act (FICA)<sup>1</sup> and the Self-Employment Contributions Act (SECA)<sup>2</sup> require the payment of employment taxes to the Federal Government that fund both the Social Security (i.e., old age, survivor, and disability insurance or OASDI) and Medicare (i.e., hospital insurance or HI) trust funds. The OASDI portion of both FICA and SECA taxes is 12.4 percent of taxable wages or self-employment income, up to a maximum earnings limit that is sometimes adjusted by statute. For Tax Year (TY) 2000, this limit was \$76,200; it has increased to \$90,000 for TY 2005. The HI portion of both FICA and SECA taxes is 2.9 percent of total taxable income.

Employers withhold FICA taxes from the wages of employees, with matching amounts paid by the employers. Employees do not pay FICA taxes on the amount paid by their employers on their behalf. Sole proprietors (i.e., individuals who own unincorporated businesses) must pay SECA taxes<sup>3</sup> on profits from the operation of their businesses. The SECA tax law treats all profits (except for an amount equal to the employer portion of FICA) as if they were wages, and the proprietor pays the equivalent of both the employer and employee portions of FICA on the profits.

In 1958, the Congress established Subchapter S of the Internal Revenue Code (I.R.C.)<sup>4</sup> that enabled small businesses, including sole proprietorships, to form corporations owned by 10 or fewer shareholders.<sup>5</sup> Electing this form of business organization, commonly referred to as

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<sup>1</sup> 26 U.S.C. Chapter 21 (2004).

<sup>2</sup> 26 U.S.C. § 1401 (2004).

<sup>3</sup> Individuals are generally subject to SECA taxes if they have net earnings from self-employment (excluding church employee income) of \$400 or more. Net earnings from self-employment generally means the net income earned by any self-employed person from a trade or business and any individual's distributive share of partnership net income or loss attributable to the partnership's trade or business.

<sup>4</sup> 26 U.S.C. Chapter 1, Subchapter S (2004).

<sup>5</sup> In TY 2000, S corporations were permitted to have up to 75 shareholders. A husband and wife are considered one shareholder for purposes of determining the number of shareholders in an S corporation. Generally, S corporation shareholders are individuals, but certain trusts, estates, charities, and qualified retirement plans may also be S corporation shareholders.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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an S corporation, exempts the profits from corporate taxation and allows the profits to “pass through” to the shareholders who are then responsible for individual income taxes on the profits received. Shareholders who actively operate the business are subject to employment taxes on compensation received for their services.

Sole proprietorships and S corporations were, respectively, the first and second most prevalent types of business organizations in TY 2000. For TY 2000, there were approximately 17.9 million sole proprietorships that reported approximately \$245 billion in profits from business operations. Also for TY 2000, approximately 2.9 million S corporations reported approximately \$200 billion in profits from business operations.

To perform the audit, we analyzed TY 2000 data collected by the Internal Revenue Service (IRS) Statistics of Income (SOI) function regarding S corporations and compared ownership information reported by S corporations to information on the IRS Individual Returns Transaction File<sup>6</sup> for TY 2000. TY 2000 was the most current year for which specific data was available from multiple sources at the time audit planning commenced. We did not attempt to identify partnerships and corporations other than S corporations that may be solely-owned or majority-owned by a single individual. Data analysis was conducted in our Cincinnati office. We did not visit any IRS offices to perform the audit. The audit was performed in accordance with *Government Auditing Standards* during the period July 2004 through February 2005. We did not test management controls since they were not significant to our audit objectives. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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<sup>6</sup> An IRS file containing data transcribed from each tax return, as well as computer-generated information used to verify the accuracy of the transcribed data.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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**Billions of Dollars in Self-Employment Taxes Are Being Avoided Each Year As Sole Proprietors Increasingly Choose to Incorporate**

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The employment tax methodology applied to S corporations does not properly address the facts and circumstances related to the predominant ownership structure of today's S corporations.<sup>7</sup> This condition is largely the result of Revenue Ruling<sup>8</sup> 59-221<sup>9</sup> issued by the IRS in 1959 because the 1958 statute establishing S corporations in tax law<sup>10</sup> was silent on the employment tax treatment of S corporation profits.

When the Revenue Ruling was issued, no S corporation tax returns had yet been filed, so the IRS based its ruling on assumptions regarding the ownership structure of S corporations. Since the law allowed up to 10 shareholders in an S corporation, the IRS apparently assumed that a majority of S corporations would involve multiple shareholders when it concluded only shareholders actively operating the business should be subject to employment taxes and only on amounts received for their services. In a multishareholder environment, it would have been reasonable to assume the salary of the business operator would be set by a consensus of shareholders at a level reflecting the market value of the operator's services.

What apparently was not anticipated was that most S corporations would eventually consist of sole proprietors who chose to incorporate without expanding ownership to include other shareholders. In TY 2000, 78.9 percent of all S corporations were either fully owned by a single shareholder (69.4 percent) or more than 50 percent owned<sup>11</sup>

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<sup>7</sup> This Treasury Inspector General for Tax Administration conclusion, as well as others throughout the report, address issues similar to those discussed in the Joint Committee on Taxation (JCT) Report *Options to Improve Tax Compliance and Reform Tax Expenditures* JCS-02-05 (January 27, 2005). Despite similarities in conclusions and recommendations, this report was developed independently and without prior knowledge of the JCT study.

<sup>8</sup> A Revenue Ruling represents the IRS' official interpretation of the I.R.C. as it applies to a particular set of facts. Revenue Rulings are intended to promote the uniform application of the tax laws and assist taxpayers in attaining maximum voluntary compliance.

<sup>9</sup> 1959-1 C. B. 225; Rev. Rul. 59-221 (January 1959).

<sup>10</sup> Pub. L. No. 85-866, 72 Stat. 1650 (1958).

<sup>11</sup> Majority ownership provides such shareholders with the ability to make unilateral decisions, such as setting officer salaries.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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by a single shareholder (9.5 percent).<sup>12</sup> Also apparently unanticipated was the fact that, when there is only one shareholder controlling and operating an S corporation, the determination of a salary is unilateral, highly subjective, and influenced by the knowledge that a higher salary will result in higher employment taxes and therefore lower profits.

One of the criteria for judging a tax system is whether similarly situated taxpayers are treated the same.<sup>13</sup> Given equal amounts of income subject to employment taxes, owners of single-shareholder S corporations and sole proprietors are similarly situated for employment tax purposes.<sup>14</sup> However, a fundamental and significant inequity is created between sole proprietors and owners of single-shareholder S corporations by the manner in which taxable income is determined. Sole proprietors pay employment taxes as a percent of all profits, while owners of single-shareholder S corporations pay employment taxes on only the portion of profits they unilaterally select as their salaries.

The 1959 Revenue Ruling that, due to unanticipated predominance of single-shareholder S corporation ownership structures, created the inequity between sole proprietors and single-shareholder S corporations has had three major detrimental effects on the tax system:

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<sup>12</sup> These statistics reflect the impact of spousal ownership. A husband and wife are considered one shareholder for purposes of determining the number of shareholders in an S corporation.

<sup>13</sup> JCT report *Description and Analysis of Proposals to Replace the Federal Income Tax* JCS-18-95 (June 5, 1995).

<sup>14</sup> Both types of taxpayers are subject to OASDI taxes of 12.4 percent on taxable income that does not exceed the annual earnings limit. This limit increases each year with increases in the national average wage index. For TY 2000, the limit was \$76,200. In TY 2005, the limit is \$90,000. Both types of taxpayers are subject to HI taxes of 2.9 percent on total taxable income. Both types of taxpayers deduct one-half of their employment taxes from their incomes for determining their individual income tax liabilities on their business profits. A sole proprietor deducts the employment taxes from the total income reported on U.S. Individual Income Tax Return (Form 1040). The owner of an S corporation deducts the employment taxes from the income reported on U.S. Income Tax Return for an S Corporation (Form 1120S), thereby reducing the pass-through income that must be reported on the Form 1040.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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- 1) The S corporation form of ownership has become a multibillion dollar employment tax shelter<sup>15</sup> for single-owner businesses (\$5.7 billion in TY 2000 alone).
- 2) Officer compensation issues have become a drain on limited IRS examination resources.
- 3) Trends point to continued erosion of the employment tax base and resulting reductions in Social Security and Medicare revenues.

**The IRS Revenue Ruling inadvertently created a multibillion dollar employment tax shelter**

The 1959 Revenue Ruling appears to influence the salary-setting decisions by the owners of single-shareholder S corporations. As shown in Figure 1, the salaries declared by the owners of S corporations have been steadily declining over the years. Owners of single-shareholder S corporations paid themselves salaries subject to employment taxes that equaled only 47.1 percent of their profits in TY 1994, which fell to just 41.5 percent by TY 2001. In contrast, unincorporated sole proprietors pay employment taxes on all of their profits.<sup>16</sup>

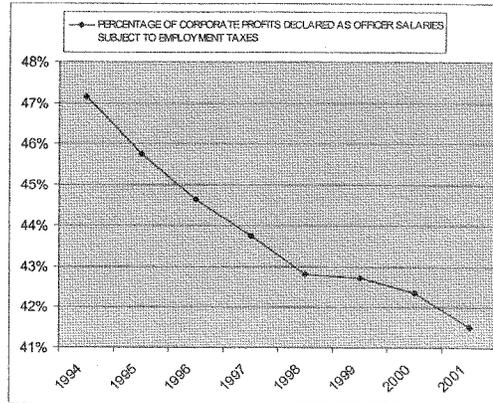
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<sup>15</sup> A tax shelter is the way of organizing a business to reduce or eliminate taxes.

<sup>16</sup> For purposes of determining employment taxes, the profits of sole proprietorships are calculated as gross income minus expenses and an amount equal to the employer's share of FICA taxes. S corporations also deduct the employer's share of FICA taxes from their income for determining profits.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

**Figure 1: Officer Salaries Declared by Single-Shareholder S Corporations As a Percentage of Operating Profits (TYs 1994 – 2001)<sup>17</sup>**



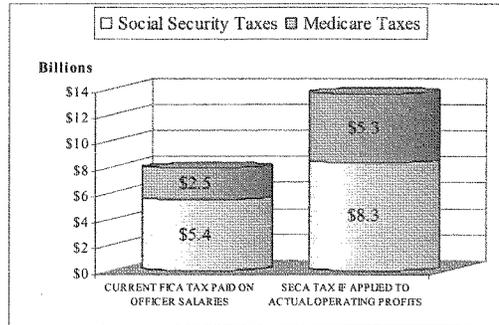
Source: IRS SOI function data.

The ability to independently set salary levels also extends to S corporation shareholders who own more than one-half of the corporation's stock, which in effect allows them the ability to make unilateral decisions, such as setting officer salaries. The ability of a single shareholder of an S corporation to set officer salaries has a significant effect on employment tax receipts. As shown in Figure 2, the amount of employment taxes paid in TY 2000 by single-shareholder S corporations was \$5.7 billion less than the SECA taxes that would have been paid if the taxpayers were unincorporated sole proprietors.

<sup>17</sup> Includes only those S corporations that filed returns reflecting one shareholder for the corporation. Officer compensation reported on the returns is expressed as a percentage of the total of officer compensation and positive net income from the operations of the single-owner S corporations.

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**Figure 2: Actual FICA Taxation vs. Theoretical SECA Taxation of S Corporations (TY 2000)<sup>18</sup>**



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS Master File<sup>19</sup> data.

In 1959, the IRS ruling appeared to have limited impact. Just 71,140 S corporations existed in TY 1959 and, of these, only 46,037 reported profits. Since the maximum amount of self-employment tax per individual was just \$180 in 1959, the maximum potential loss of self-employment tax revenue in 1959 would have been only \$8.3 million (\$49.1 million in Calendar Year (CY) 2000 dollars).<sup>20</sup>

However, the 1959 ruling does not reflect conditions in today's business and tax environments. A number of factors have combined to significantly increase the employment tax consequences of the IRS decision.

<sup>18</sup> Represents the FICA taxes applicable to officer compensation paid, allocated according to the percentage of ownership for those shareholders owning more than 50 percent of the shares of the S corporations. We computed the SECA taxes based upon the total of officer compensation plus the amount of positive net income from the operation of the business, allocated based upon the percentage of ownership. See Appendix IV for additional information.

<sup>19</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>20</sup> Assumes that all of the S corporations had only one shareholder and no salaries were paid to shareholders.

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- The SECA tax rate on earnings at or below the maximum limit was four times higher for TY 2000 than it was for TY 1959.
- The maximum earnings limit for TY 2000 was 16 times higher than it was for TY 1959.
- The Medicare tax (which did not exist in 1959) was assessed on unlimited earnings in TY 2000.
- The number of S corporations that existed in TY 2000 was 40 times higher than that in TY 1959.
- In TY 2000, approximately 54.6 percent of all S corporations reported to the IRS that they were owned by a single shareholder.
- In reality, 78.9 percent of all S corporations were either fully owned by a single shareholder (69.4 percent) or majority owned by a single shareholder (9.5 percent) for TY 2000 when spousal ownership was taken into account.<sup>21</sup>

Thus, historical increases in employment tax rates and the ability of nearly 80 percent of S corporation owners to minimize their employment taxes by minimizing their salaries combined to transform the original \$8.3 million maximum potential self-employment tax revenue cost into an estimated \$5.7 billion revenue cost in TY 2000.

**The IRS has limited resources for combating abuses**

On a mass scale, it is extremely difficult for the IRS to alleviate the serious problem of self-employment tax avoidance by S corporations. Revenue Ruling 59-221, in effect, places the burden on the IRS to prove that officer compensation was not "reasonable" (i.e., commensurate with the services the shareholder provided to the S corporation). Therefore, the IRS must examine the

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<sup>21</sup> A husband and wife are considered one shareholder for purposes of determining the number of shareholders in an S corporation. To determine actual S corporation ownership, we relied upon data from Shareholder's Share of Income, Credits, Deductions, etc. (Schedule K-1) of Form 1120S provided by the IRS SOI function and compared those data to spousal information on Form 1040 tax returns filed for TY 2000.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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S corporation returns and supporting business records to make reasonable compensation determinations.

As shown in Figure 3, however, the IRS is able to examine only a small fraction of the S corporation returns that are filed each year. Between Fiscal Years (FY) 1996 and 2003, the examination coverage rates for S corporation returns ranged from a high of 1.04 percent to a low of 0.30 percent in the most recent year.

**Figure 3: Examination Rates for S Corporation Returns  
(FYs 1996 – 2003)**

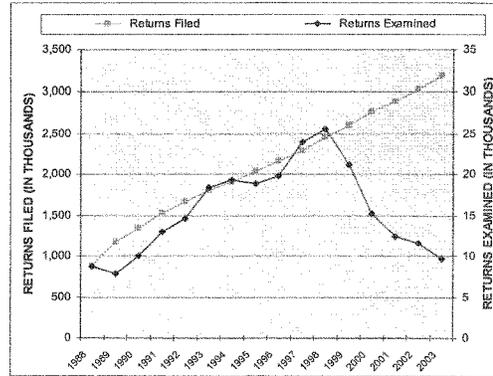
<b>Fiscal Year</b>	<b>Returns Examined</b>	<b>Coverage Rate</b>
1996	19,490	0.92%
1997	23,898	1.04%
1998	25,522	1.04%
1999	21,169	0.81%
2000	15,200	0.55%
2001	12,437	0.43%
2002	11,646	0.39%
2003	9,695	0.30%

*Source: TIGTA analysis of IRS data.*

In addition, Figure 4 shows the IRS examination coverage of S corporation returns in the past 5 years has been insufficient to keep pace with the steady growth in the number of returns filed.

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**Figure 4: Examination Coverage of S Corporation Returns  
(FYs 1988 – 2003)**



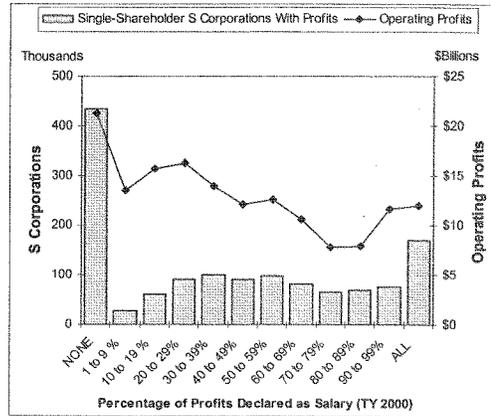
Source: IRS Data Books – Table 11.

Making reasonable compensation determinations is a complex and somewhat subjective endeavor that can result in litigation for the IRS. Since the IRS is forced to address the issue of reasonable officer compensation on a case-by-case basis, there are evidently many owners of S corporations who have determined the employment tax savings available from minimizing salaries is worth the risk of an IRS examination.

As shown in Figure 5, owners of single-shareholder S corporations vary widely in the amount of risk they wish to assume. As shown in the far left column, many are willing to set their salaries at \$0 to maximize their employment tax savings.

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**Figure 5: Variations in Salaries Selected by Owners of Single-Shareholder S Corporations (TY 2000)<sup>22</sup>**



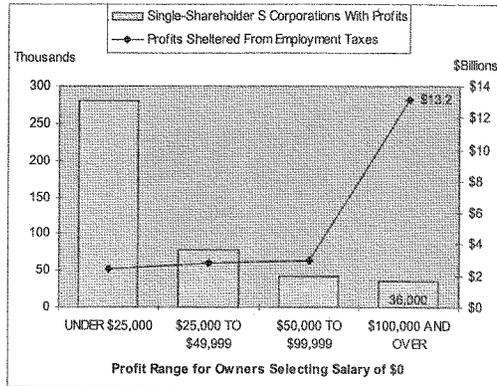
Source: TIGTA analysis of IRS Master File Data. These data reflect the impact of S corporation spousal ownership but not majority ownership.

Significant amounts of business profits frequently accrue to the owners of single-shareholder S corporations who choose to pay themselves no salaries and, therefore, pay no employment taxes. As shown in Figure 6, approximately 36,000 single-shareholder S corporations with profits of \$100,000 or more in TY 2000 passed through total profits of \$13.2 billion to their owners without paying any employment taxes.

<sup>22</sup> The profits of the single-shareholder S corporations consist of operating net income as reflected on corporate returns filed plus officer compensation. Officer compensation is included to ensure comparability with sole proprietorships for which similar payments are not deductible for computing net income from operations. Amounts for S corporations are for only those corporations filing returns claiming only one shareholder.

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**Figure 6: Operating Profits of S Corporations That Paid No Salaries to the Sole Owners (TY 2000)<sup>23</sup>**



Source: TIGTA analysis of IRS Master File Data. These data reflect the impact of S corporation spousal ownership but not majority ownership.

Court records show the IRS can enforce reasonable compensation determinations through costly litigation. For example, in a recent tax court case,<sup>24</sup> a veterinarian who was the sole shareholder in his S corporation had received 3 years of profits from the business totaling nearly \$419,000 while declaring no salary for himself, despite the fact the S corporation's sole source of income was from the services he provided. The court agreed with the IRS that the taxpayer's profits should be subject to employment taxes.

While such successes are helpful, there were 36,000 similar situations (see Figure 6) in TY 2000 alone in which the owners of single-shareholder S corporations took no salaries from the businesses while having over \$100,000 in income.

<sup>23</sup> Figure 6 is composed of those companies represented by the left-most column of Figure 5. The same footnote applies to Figure 6. Profits exempted from employment taxes represent the positive net income from the operation of the single-owner S corporations, as reported on corporate tax returns filed.

<sup>24</sup> *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141 (2001).

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The cost of the IRS resources needed to effectively combat such a large problem on a case-by-case basis would be prohibitive.

If the S corporation owners who now have the ability to set their own salaries were instead subject to employment taxes on their profits, as are unincorporated sole proprietors, we estimate that Social Security and Medicare tax revenues would increase by \$30.8 billion and \$30.2 billion, respectively, during the 5-year period from CYs 2006 to 2010. This change would also allow the IRS to devote scarce compliance resources to examination priorities other than reasonable compensation determinations. See Appendix IV for additional information.

**Trends indicate continued erosion of the employment tax base**

The number of single-shareholder S corporations (as reported on U.S. Income Tax Returns for an S Corporation (Form 1120S)) grew from 1,030,716 in TY 1994 to 1,684,861 in TY 2001, a growth rate of 63.5 percent. While there may be other reasons for small businesses to choose the S corporation form of organization, the opportunity to choose how much to pay for employment taxes must certainly be a consideration.

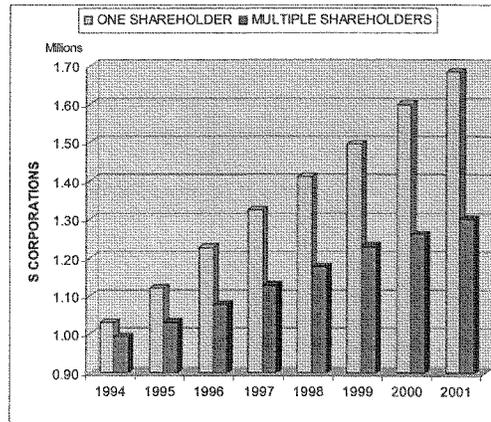
In fact, advising small businesses to shelter earnings from self-employment taxes through the formation of S corporations has become a cottage industry. A search of the Internet yields multiple sites that offer advice, assistance, and encouragement to sole proprietors to convince them to become S corporations. The sole proprietors are advised they can save thousands of dollars a year in employment taxes simply by incorporating. It is also possible on the Internet to gauge the size of the savings using computer-generated savings amounts based on the user's entries for anticipated profits and chosen salary levels. Not surprisingly, the lower the salary chosen, the higher the savings become, reaching maximum savings at a salary level of \$0.

Figure 7 shows the growth in the numbers of single-shareholder and multiple-shareholder S corporations as reported to the IRS on S corporation returns. Although

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Figure 7 shows that there are far more single-shareholder S corporations than multiple-shareholder S corporations, our analysis of taxpayer data revealed that the imbalance is significantly more pronounced than is shown in Figure 7.

**Figure 7: Growth in Single-Owner and Multiple-Owner S Corporations (TYs 1994 - 2001)<sup>25</sup>**



*Source: IRS SOI function. These data do not reflect the impact of S corporation spousal or majority ownership.*

Approximately 54.6 percent of all S corporations reported that they were owned by a single shareholder in TY 2000. However, this does not reflect the fact that tax law<sup>26</sup> treats a husband and wife as 1 shareholder or the fact that ownership of more than 50 percent of a corporation's stock by a single shareholder gives that shareholder control of business decisions, including the amount of business profits that will be paid to that individual as a salary.

By accounting for these factors, we determined that, in TY 2000, 78.9 percent of all S corporations are either owned by a single shareholder (69.4 percent) or majority owned by a single shareholder (9.5 percent).

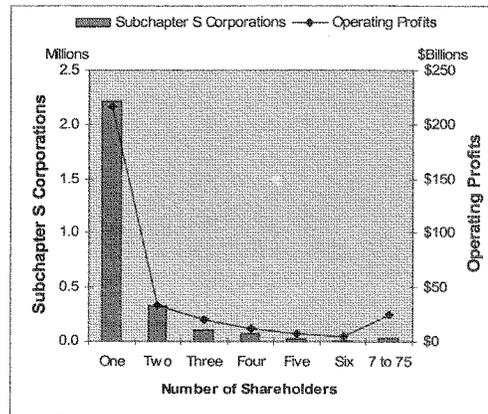
<sup>25</sup> Analysis reflects the number of shareholders shown on Forms 1120S.

<sup>26</sup> 26 U.S.C § 1361(c)(1) (2004).

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Figure 8 demonstrates the true predominance of single-shareholder S corporations in TY 2000, as well as the sizable portion of business income related to single-shareholder S corporations. The left-most column in Figure 8 shows the operating profits<sup>27</sup> and the volume of S corporations that were either solely owned or solely controlled by a single shareholder. The remaining columns show the S corporations with more diverse ownership.

**Figure 8: Number of S Corporations and Operating Profits Stratified by Number of Shareholders (TY 2000)**



Source: TIGTA analysis of IRS SOI function and Individual Master File Data. These data reflect the impact of S corporation spousal and majority ownership.

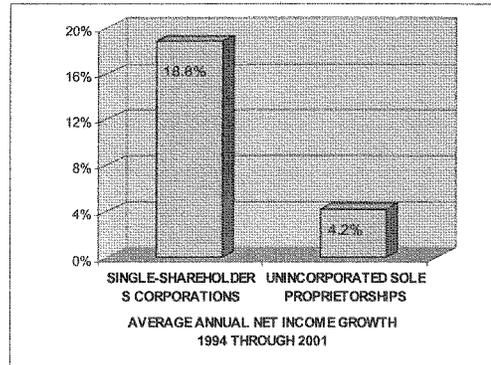
The trend toward single-shareholder S corporations may account for the relatively slow growth of business profits that are subject to SECA taxes seen in Figure 9. The average annual growth in net income from the operation of

<sup>27</sup> For comparability to sole proprietorships, the operating profits shown represent the total positive net income from the operation of the businesses plus officer compensation paid (which is not a deductible item for determining the net income of a sole proprietorship). The total positive net income is from line 21 of Form 1120S.

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single-shareholder S corporations<sup>28</sup> between TYs 1994 and 2001 was 18.8 percent. The average annual growth in net income from the operation of sole proprietorships was only 4.2 percent during the same period.

**Figure 9: Average Annual Growth in Net Operating Income of S Corporations and Sole Proprietorships (TYs 1994 – 2001)**



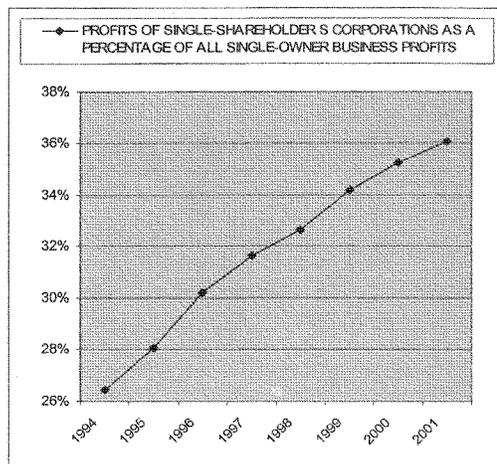
*Source: IRS SOI function data. These data do not reflect the impact of S corporation spousal or majority ownership.*

The continuing migration of sole proprietors to the S corporation structure diverts business profits away from the SECA tax base into S corporations where the amount of FICA taxes that will be generated is significantly less, due to the subjectivity of establishing reasonable officer compensation. Figure 10 shows that single-shareholder S corporations accounted for 26.4 percent of the combined profits of sole proprietorships and single-shareholder S corporations in TY 1994 and 36.1 percent in TY 2001, an increase of nearly 10 percentage points in just 8 years.

<sup>28</sup> Represents positive net income from business operations minus net deficits as reported on line 21 of Form 1120S. Amounts on line 21 are net of officer compensation which is not a deductible item in determining the net income of sole proprietorships.

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**Figure 10: Operating Profits of Incorporated and Unincorporated Single-Owner Businesses (TYs 1994 – 2001)<sup>29</sup>**



*Source: IRS SOI function data. These data do not reflect the impact of S corporation spousal or majority ownership.*

### Recommendations

To eliminate the employment tax shelter for most S corporations, increase self-employment tax revenues, provide for equitable employment tax treatment of taxpayers, and reduce the burden on IRS examination resources:

<sup>29</sup> Represents the total positive net income from the operation of sole proprietorships plus the positive net income from the operation of single-shareholder S corporations. The net income for the single-shareholder S corporations includes officer compensation paid to ensure comparability with sole proprietorships for which similar payments are not deductible for computing net income. Amounts for S corporations are for only those corporations filing returns claiming only one shareholder. No adjustments have been made for spousal or majority ownership. Figure 10 excludes partnerships and corporations other than S corporations that may be solely-owned or majority-owned by a single individual.

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1. The IRS Commissioner should inform the Assistant Secretary of the Treasury for Tax Policy of the detrimental effects discussed in this report of Revenue Ruling 59-221 that was apparently issued under the historically inaccurate assumption that most S corporations would involve multiple shareholders.

Management's Response: The Commissioner, Small Business/Self-Employed (SB/SE) Division, did not agree with this recommendation. The Commissioner, SB/SE Division, disagrees that Revenue Ruling 59-221 is the cause of the inequities reflected in the report. The issue is not with Revenue Ruling 59-221. In fact, the statutory and judicial laws that form the basis for Revenue Ruling 59-221 are still the law today. The Commissioner, SB/SE Division, stated, under current law for S corporations, the issue is how best to determine "reasonable compensation" for application of the FICA tax.

Office of Audit Comment: We continue to believe the current employment tax inequities are the result of the Revenue Ruling. The historical file for this Revenue Ruling shows the Revenue Ruling was prompted by a 1958 question from a taxpayer regarding whether or not self-employment taxes (applicable to sole proprietors) would apply to the profits of the newly-created S corporations. Rather than addressing the case of a sole proprietor choosing to become a single-shareholder S corporation, the IRS response discussed a multi-shareholder S corporation and concluded that self-employment taxes should not apply to the profits of such S corporations. The IRS applied the concepts supporting this decision to all S corporations, regardless of the number of shareholders, when it issued Revenue Ruling 59-221 in 1959.

2. The IRS Commissioner should consult with the Assistant Secretary of the Treasury for Tax Policy regarding whether the detrimental effects of Revenue Ruling 59-221 should be reversed through the issuance of new regulations or through the drafting of new legislation, either of which should subject all ordinary operating gains of an

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S corporation that accrue to a shareholder (including the shareholder's spouse and dependent children) holding more than 50 percent of the stock in the S corporation to employment taxes.

- a. SECA taxes should not apply to officer compensation (if any) on which FICA taxes are paid.
- b. No employment taxes should apply to S corporations without operating gains.
- c. No changes should be made to the current employment tax treatment of S corporation minority shareholders.

Management's Response: The Commissioner, SB/SE Division, does not agree with this recommendation. The Commissioner, SB/SE Division, stated new regulations would not affect the fundamental application of employment taxes to S corporations. A recommendation to discuss legislative changes to simply subject to employment tax "all ordinary operating gains of an S corporation that accrue to a shareholder" is not consistent with the principles underlying the employment tax statutes in connection with the performance of services. Nor does it properly recognize the administrative and taxpayer burdens that this legislation may cause or consider the application of employment taxes to other flow-through entities. However, the IRS will continue its outreach efforts to communicate all employment tax provisions as they pertain to each tax entity. As appropriate, the IRS will work with the Department of the Treasury in furtherance of legislation that would resolve the issues in the best interest of tax administration.

Because the Commissioner, SB/SE Division, does not agree with our premise that the source of the problem is the revenue ruling and believes it is important to consider the problem in the context of other business entities, the Commissioner, SE/SE Division, does not agree with the specific recommendations of this report and, therefore, cannot agree with the outcome measures. The Commissioner, SB/SE Division, also has concerns with our calculation of the outcome measures. The Commissioner,

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SB/SE Division, stated the calculation does not take into account that some taxpayers may react to implementation of the proposal by converting S corporations to another entity (such as a C corporation or a limited liability company). The Commissioner, SB/SE Division, also stated our report assumes the S corporation shareholder has no other self-employment income (or FICA tax wages) and does not account for an offset to self-employment taxes for any S corporation that will reflect an ordinary loss.

Office of Audit Comment: We disagree with the IRS assertion that Revenue Ruling 59-221 *confirmed* rather than established that SECA taxes should not apply to single-shareholder S corporations, and we continue to believe that the current employment tax inequities are the result of the Revenue Ruling. However, we are encouraged that the IRS plans to work with the Department of the Treasury in furtherance of legislation that would resolve the issues in the best interest of tax administration.

While we support the IRS desire to eliminate through such legislation similar employment tax inequities in other business structures, identifying and quantifying such possible additional inequities were beyond the scope of this review. In addition, we do not believe correction of the current inequities discussed in the report should be delayed while a search for possible additional inequities is conducted. Nor do we believe current inequities should continue out of apprehension that an unquantifiable number of taxpayers may change their business structures to pursue new strategies to avoid employment taxes.

In response to IRS concerns related to the possible impact of taxpayers having multiple sources of employment-taxable income, we have reduced our original 5-year estimate of additional employment tax revenues to \$61 billion. See Appendix IV for additional information. In addition, we have added notes (a) through (c) to this recommendation to clarify our position on the uncertainties expressed in IRS management's response.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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**Appendix I**

**Detailed Objective, Scope, and Methodology**

The overall objective of this review was to determine whether the existing tax laws, tax regulations, and Internal Revenue Service (IRS) policies and practices ensure fairness in administering self-employment taxes to all similarly situated taxpayers.

To accomplish this objective, we:

- I. Researched historical tax law changes regarding sole proprietors and S corporations and, where possible, identified the reasons for those changes.
- II. Reviewed available IRS studies, reports, and general information regarding self-employment taxes and related compliance information, including tax court cases.
- III. Identified and evaluated the characteristics of S corporations by analyzing databases that were developed by the IRS Statistics of Income (SOI) function for Tax Year (TY) 2000 U.S. Income Tax Return for an S Corporation (Form 1120S) and related Shareholder's Share of Income, Credits, Deductions, etc. (Schedule K-1). TY 2000 was the most current year for which specific data was available from multiple sources at the time audit planning commenced.
  - A. To determine the presence of spousal ownership among the shareholders in S corporations, matched the Schedule K-1 data to the IRS Individual Returns Transaction File<sup>1</sup> for TY 2000 to identify the shareholders in the same S corporation that filed jointly or as married filing separately for TY 2000.
  - B. Once the spousal ownership test was completed, identified all shareholders owning more than 50 percent of the stock in an S corporation (regardless of whether the stock was owned by 1 spouse or both).
- IV. Evaluated historical trends regarding both nonfarm sole proprietorships and S corporations by analyzing statistics published by the SOI function from 1959 to 2001.
- V. Researched Social Security Administration (SSA) records regarding the historical rates for Federal Insurance Contributions Act<sup>2</sup> and Self-Employment Contributions Act<sup>3</sup> tax rates as well as the annual contribution bases for the SSA's Old-Age, Survivors, and Disability Insurance .
- VI. Researched Internet sites for applicable information and advice offered to the public regarding employment taxes.

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<sup>1</sup> An IRS file containing data transcribed from each tax return as well as computer-generated information used to verify the accuracy of the transcribed data.

<sup>2</sup> 26 U.S.C. Chapter 21 (2004).

<sup>3</sup> 26 U.S.C. § 1401 (2004).

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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**Appendix II**

**Major Contributors to This Report**

Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)  
William E. Stewart, Audit Manager  
Theodore J. Lierl, Lead Auditor  
Stanley M. Pinkston, Senior Auditor  
James M. Allen, Information Technology Specialist  
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Kevin O’Gallagher, Information Technology Specialist

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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Appendix III

**Report Distribution List**

Commissioner C  
 Office of the Commissioner – Attn: Chief of Staff C  
 Assistant Deputy Commissioner for Services and Enforcement SE  
 Commissioner, Large and Mid-Size Business Division SE:LM  
 Commissioner, Small Business/Self-Employed Business Division SE:S  
 Chief Counsel CC  
 Deputy Commissioner, Large and Mid-Size Business Division SE:LM  
 Deputy Commissioner, Small Business/Self-Employed Business Division SE:S  
 Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS  
 Director, Communications, Government Liaison, and Disclosure, Small Business/Self-Employed Division SE:S:CGL&D  
 Director, Examination, Small Business/Self-Employed Division SE:S:E  
 Director, Strategy, Research, and Program Planning, Large and Mid-Size Business Division SE:LM:SR  
 National Taxpayer Advocate TA  
 Director, Office of Legislative Affairs CL:LA  
 Director, Office of Program Evaluation and Risk Analysis RAS:O  
 Office of Management Controls OS:CFO:AR:M  
 Audit Liaisons:  
     Deputy Commissioner for Services and Enforcement SE  
     Commissioner, Large and Mid-Size Business Division SE:LM  
     Commissioner, Small Business/Self-Employed Division SE:S

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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**Appendix IV**

**Outcome Measures**

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration for Calendar Years 2006 through 2010. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$30.8 billion in increased Social Security tax revenues from S corporation shareholders owning more than 50 percent of the stock in the corporations (see page 3).
- Increased Revenue – Potential; \$30.2 billion in increased Medicare tax revenues from S corporation shareholders owning more than 50 percent of the stock in the corporations (see page 3).

Methodology Used to Measure the Reported Benefit:

To determine the number of solely owned and solely controlled (i.e., a single shareholder with more than 50 percent ownership) S corporations, we relied on the percentage of ownership information reflected on Shareholder's Share of Income, Credits, Deductions, etc. (Schedule K-1) that was developed by the Internal Revenue Service (IRS) Statistics of Income (SOI) function for Tax Year (TY) 2000 U.S. Income Tax Return for an S Corporation (Form 1120S). We enhanced this information by matching the Social Security Numbers (SSN)<sup>1</sup> from the Schedules K-1 to an extract from the Individual Master File<sup>2</sup> that contained the primary and secondary SSNs and the filing status from each individual income tax return filed for TY 2000. If both the primary and secondary SSNs matched one return and both SSNs matched the Schedules K-1 issued by the same S corporation, we totaled the percentage ownership from the Schedules K-1 and reduced the number of shareholders shown on the S corporation return by one.

After this analysis was complete, we identified all S corporations with more than 50 percent ownership as modified for spousal ownership. To determine the income received by these taxpayers from their S corporations, we multiplied the total operating profits of the S corporations by the percentage of ownership of the taxpayers. To determine the operating profits of the S corporations on a basis equivalent to Self-Employment Contributions Act

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<sup>1</sup> The SSN is generally used as a taxpayer identification number that must be used on U.S. Individual Income Tax Return (Form 1040) and its related schedules.

<sup>2</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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(SECA)<sup>3</sup> tax treatment of sole proprietors, we added officer compensation to the net income (or deficit) from the operation of the trade or business. Although both Federal Insurance Contributions Act (FICA)<sup>4</sup> taxes and SECA taxes are virtually identical on this amount (as explained on page 3 of this report) and officer compensation is not a deductible amount for determining operating income for sole proprietors, the change was necessary for clarity of discussion and SECA tax computations and for comparability of S corporation profits and sole proprietorship profits. Both the unadjusted operating net income and the amount of officer compensation were obtained from the TY 2000 Form 1120S database developed by the IRS SOI function.

To determine the amount of FICA Social Security taxes currently paid by taxpayers owning more than 50 percent of an S corporation, we multiplied the taxpayer's percentage of ownership by the amount of officer compensation for the S corporation and then multiplied the result, limited to the TY 2000 Social Security income ceiling of \$76,200, by 12.4 percent. Our computations assumed the taxpayer had no other income subject to Social Security taxes. To determine the amount of FICA Medicare taxes currently paid, we multiplied all of the taxpayer's officer compensation by 2.9 percent.

To determine the amount of SECA taxes that would be paid on the taxpayer's share of the operating profit from the S corporation, we applied the SECA tax rules to the total of operating net income plus officer compensation that exceeded zero. In the case of officer compensation that was partially or wholly in excess of available gains, we computed no SECA taxes on the portion of the officer compensation that exceeded the available gains. The operating profits were multiplied by 92.35 percent<sup>5</sup> to determine the taxable SECA base. To determine the amount of SECA taxes that would be assessed on the taxable SECA base, we multiplied the taxpayer's operating profits, limited to the TY 2000 Social Security income ceiling of \$76,200, by 12.4 percent. Our computations assumed the taxpayer had no other Social Security-taxable income for the year, but the presence of such income would reduce both taxable FICA income and taxable SECA income and, thus, would not materially affect the difference between the FICA and SECA taxation computed by the Treasury Inspector General for Tax Administration (TIGTA). To determine the amount of SECA Medicare taxes that would be paid, we multiplied the taxable SECA base by 2.9 percent. To produce national statistics, the record weights<sup>6</sup> provided by the SOI function on all TY 2000 Form 1120S database items were applied to all taxpayer counts and amounts.

To determine the increase or decrease that would result from subjecting S corporations to SECA taxes, we compared the amount of FICA taxes currently paid on officer compensation to the amount of SECA taxes that would be assessed if they were applied, instead, to all operating

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<sup>3</sup> 26 U.S.C. § 1401 (2004).

<sup>4</sup> 26 U.S.C. Chapter 21 (2004).

<sup>5</sup> For purposes of determining employment taxes, the profits of sole proprietorships are reduced by an amount equal to an employer's share of FICA taxes (7.65 percent) before calculating SECA taxes on the remaining 92.35 percent.

<sup>6</sup> Record weights are values that indicate how many records similar to the sampled record would likely be found if all records were examined.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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profits. To determine these future amounts, our computer programs totaled all applicable FICA and SECA amounts and we then expressed these amounts as a percentage of officer compensation (for FICA taxes) or operating profits (for SECA taxes). The future annual growth in officer compensation (7.70 percent) and operating profits (9.60 percent) were based upon average annual increases in those items from TYs 1999 through 2001 according to SOI function data published by the IRS. While the average annual growth in single-owner S corporation profits from TYs 1995 through 2001 was 12.77 percent, we used a more conservative average annual profit growth rate of 9.60 percent for TYs 1999 through 2001 for our analysis to more closely reflect recent economic conditions.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

**Table 1: Employment Tax Revenue Losses Before SECA Taxes Can Be Applied to Single-Owner S Corporations**

	TY 2000 ACTUAL DUE IN CY 2001	TY 2001 DUE IN CY 2002	TY 2002 DUE IN CY 2003	TY 2003 DUE IN CY 2004	TY 2004 DUE IN CY 2005	TY 2005 DUE IN CY 2006
A) Average Annual S Corporation Officer Compensation Growth (Actual TY 1999 Through TY 2001)	7.70%	7.70%	7.70%	7.70%	7.70%	7.70%
B) Officer Compensation of Single-shareholder S Corporations Through TY 2005 (CY 2006)	\$ 84,725,792,928	\$ 91,249,678,981	\$ 98,275,904,263	\$105,843,148,891	\$113,993,071,356	\$ 122,770,537,850
C) FICA Old Age, Survivor, and Disability Insurance (OASDI) Tax Liability as a Percentage of Profits (OASDI on Actual TY 2000 Officer Compensation)	6.43%	6.43%	6.43%	6.43%	6.43%	6.43%
D) FICA Hospital Insurance (HI) Tax Liability as a Percentage of Profits (Actual TY 2000)	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%
E) FICA OASDI Revenue Anticipated (Item B * Item C)	\$ 5,444,396,462	\$ 5,863,615,011	\$ 6,315,113,367	\$ 6,801,377,096	\$ 7,325,083,132	\$ 7,889,114,534
F) FICA HI Revenue Anticipated (Item B * Item D)	\$ 2,457,047,995	\$ 2,646,240,890	\$ 2,850,001,224	\$ 3,069,451,318	\$ 3,305,799,069	\$ 3,580,345,598
G) Total FICA Revenue Anticipated (Item E + Item F)	\$ 7,901,444,477	\$ 8,509,855,701	\$ 9,165,114,590	\$ 9,870,828,414	\$ 10,630,882,202	\$ 11,449,460,131
H) Average Annual S Corporation Profit Growth (Actual TY 1999 Through TY 2001)	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%
I) Profits of Single-Shareholder S Corporations Through TY 2005 (CY 2006)	\$ 198,615,942,141	\$ 217,683,072,587	\$238,580,647,555	\$261,484,389,720	\$286,586,891,133	\$ 314,099,232,682
J) SECA OASDI Revenue as a Percentage of Profits (SECA OASDI Applied to Actual TY 2000 Operating Profits, Including Officer Compensation)	4.18%	4.18%	4.18%	4.18%	4.18%	4.18%
K) SECA HI Revenue as a Percentage of Profits (SECA HI Applied to Actual TY 2000 Operating Profits, Including Officer Compensation)	2.68%	2.68%	2.68%	2.68%	2.68%	2.68%
L) SECA OASDI Revenue Anticipated (Item J * Item I)	\$ 8,295,204,859	\$ 9,092,640,635	\$ 9,965,534,136	\$ 10,922,225,413	\$ 11,970,759,053	\$ 13,119,951,922
M) SECA HI Revenue Anticipated (Item K * Item I)	\$ 5,319,232,854	\$ 5,829,879,208	\$ 6,389,547,812	\$ 7,002,944,183	\$ 7,675,226,825	\$ 8,412,048,600
N) Total SECA Revenue Anticipated (Item L + Item M)	\$ 13,615,437,813	\$ 14,922,519,843	\$ 16,355,081,748	\$ 17,925,169,596	\$ 19,645,985,877	\$ 21,532,000,522
O) OASDI Revenue Loss (Item L minus Item E)	\$ 2,851,808,477	\$ 3,229,025,624	\$ 3,650,420,769	\$ 4,120,848,317	\$ 4,645,675,920	\$ 5,230,837,388
P) HI Revenue Loss (Item M minus Item F)	\$ 2,862,184,860	\$ 3,183,638,519	\$ 3,539,546,369	\$ 3,933,492,865	\$ 4,369,427,759	\$ 4,851,703,002
Q) Total Employment Tax Loss (Item O + Item P)	\$ 5,713,993,337	\$ 6,412,664,142	\$ 7,189,967,158	\$ 8,054,341,182	\$ 9,015,103,679	\$ 10,082,540,390

Source: TIGTA analysis of IRS data. Minor differences may result from the rounding of multiplicands.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

**Table 2: Employment Tax Revenue Increases From Applying SECA Taxes to Single-Owner S Corporation Profits**

	TY 2005 DUE IN CY 2006	TY 2006 DUE IN CY 2007	TY 2007 DUE IN CY 2008	TY 2008 DUE IN CY 2009	TY 2009 DUE IN CY 2010	TOTAL
AA) Average Annual S Corporation Officer Compensation Growth (Actual TY 1999 through TY 2001)	7.70%	7.70%	7.70%	7.70%	7.70%	N/A
AB) Officer Compensation of Single-Shareholder S Corporations Through TY 2005 (CY 2006)	\$ 122,770,537,850	\$ 132,223,869,265	\$ 142,405,107,198	\$ 153,370,300,452	\$ 165,179,813,587	\$ 715,949,628,353
AC) FICA OASDI Revenue as a Percentage of Profits (Actual TY 2000)	6.43%	6.43%	6.43%	6.43%	6.43%	N/A
AD) FICA HI Revenue as a Percentage of Profits (Actual TY 2000)	2.90%	2.90%	2.90%	2.90%	2.90%	N/A
AE) FICA OASDI Revenue Anticipated (Item AC * Item AB)	\$ 7,869,114,534	\$ 8,496,576,353	\$ 9,150,812,732	\$ 9,855,425,312	\$ 10,614,293,061	\$ 46,006,221,992
AF) FICA HI Revenue Anticipated (Item AD * Item AB)	\$ 3,560,345,898	\$ 3,834,492,209	\$ 4,129,748,109	\$ 4,447,738,713	\$ 4,790,214,594	\$ 20,762,539,222
AG) Total FICA Revenue Anticipated (Item AE + Item AF)	\$ 11,449,460,131	\$ 12,331,068,561	\$ 13,280,560,841	\$ 14,303,164,025	\$ 15,404,507,655	\$ 66,768,761,214
AH) Average Annual S Corporation Profit Growth (Actual TY 1999 Through TY 2001)	9.60%	9.60%	9.60%	9.60%	9.60%	N/A
AI) Profits of Single-Shareholder S Corporations Through TY 2005 (CY 2006)	\$ 314,099,232,682	\$ 344,252,759,020	\$ 377,301,023,886	\$ 413,521,922,179	\$ 453,220,026,708	\$ 1,902,394,964,474
AJ) SECA OASDI Tax as a Percentage of Profits (Actual TY 2000)	4.18%	4.18%	4.18%	4.18%	4.18%	N/A
AK) SECA HI Tax as a Percentage of Profits (Actual TY 2000)	2.68%	2.68%	2.68%	2.68%	2.68%	N/A
AL) SECA OASDI Tax Amount Anticipated (Item AJ * Item AI)	\$ 13,119,951,922	\$ 14,379,487,309	\$ 15,759,896,167	\$ 17,272,846,200	\$ 18,931,039,435	\$ 79,463,201,029
AM) SECA HI Tax Amount Anticipated (Item AK * Item AI)	\$ 8,412,048,800	\$ 9,219,605,266	\$ 10,104,687,371	\$ 11,074,737,359	\$ 12,137,912,145	\$ 50,948,990,741
AN) Total SECA Taxes Anticipated (Item AL + Item AM)	\$ 21,532,000,522	\$ 23,599,072,572	\$ 25,864,583,539	\$ 28,347,583,558	\$ 31,068,951,580	\$ 130,412,191,771
AO) OASDI Revenue Increase (Item AL minus Item AE)	\$ 5,230,837,388	\$ 5,882,890,953	\$ 6,609,083,436	\$ 7,417,420,887	\$ 8,316,746,373	\$ 33,456,979,038
AP) HI Revenue Increase (Item AM minus Item AF)	\$ 4,851,703,002	\$ 5,385,113,057	\$ 5,974,939,262	\$ 6,628,998,646	\$ 7,347,697,551	\$ 30,186,451,519
AQ) Total Employment Tax Increase (Item AO + Item AP)	\$ 10,082,540,390	\$ 11,268,004,010	\$ 12,584,022,698	\$ 14,044,419,533	\$ 15,664,443,925	\$ 63,643,430,557

Source: TIGTA analysis of IRS data. Minor differences may result from the rounding of multiplicands.

To address concerns expressed by the IRS in response to this report regarding the impact of single-shareholder S corporation owners who may have employment-taxable income from multiple sources, we conducted further analysis. Such multiple sources of employment-taxable income would include multiple single-shareholder S corporations owned by one individual and wages received by the owner of a single-shareholder S corporation for services not related to the single-shareholder S corporation. Multiple-source employment-taxable income would not impact HI revenue which applies to all employment-taxable earnings. However, it could impact OASDI taxes that in TY 2000 were assessed on only the first \$76,200 of such income. SOI records for TY 2000 indicate that 2 percent of single-shareholder S corporations are owned by taxpayers that own more than 1 single-shareholder S corporation. Information was not available regarding non-S corporation wage income for the owners of single-shareholder S corporations, so we relied on data regarding sole proprietors to gauge the impact of

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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wage-related employment taxes on such income. The IRS Individual Return Master File records for TY 2000 indicates that 5.9 percent of sole proprietors at least partially reduced their self-employment taxes due to employment taxes paid on wages. To maximize the reduction in our 5-year revenue increases, we added these percentages and assumed that the OASDI increases would be completely eliminated for 7.9 percent of the owners of single-shareholder S corporations whose OASDI increases involved employment-taxable income from multiple sources. This reduced our original OASDI estimated increase to 92.1 percent (100 - 7.9) of the original \$33,456,979,038, resulting in a revised estimate of \$30,813,877,694 in OASDI increases.

**Implications of Officer Compensation Allocation**

The recipient of officer compensation from an S corporation is not identified on Forms 1120S or the Schedules K-1 attached to those returns. As a result, it was necessary to make assumptions regarding the amount of compensation (salary) paid to the sole owners or majority owners of the corporations. For our calculations, we distributed officer compensation according to the percentage of ownership shown on Schedules K-1 of Forms 1120S, as adjusted for spousal ownership. The FICA taxes were then computed on the amount of officer compensation and the SECA taxes were computed on the total profits available for distribution by the S corporation (consisting of officer compensation plus nonofficer-compensation profits). The difference between the FICA and SECA taxes was then calculated.

**Implications for fully-owned S corporations:** For S corporations owned by a single shareholder, we allocated all officer compensation to the shareholder. If, as an extreme example, all of the officer compensation was actually paid to someone other than the single shareholder, the amount of FICA taxes paid by the single shareholder would be reduced to \$0, leaving the total amount of SECA taxes on the nonofficer compensation (business operating profits) as the total difference between the FICA tax of \$0 and SECA taxes that would be applied to the business operating profits. In this case, the business profits of up to \$76,200 (the Social Security taxable limit) that were not subject to Social Security taxes for SECA purposes (because they were above the Social Security Administration limit when officer compensation was added to operating profits) would now be subjected to SECA taxes of 12.4 percent, which would increase the difference between FICA taxes (\$0 in this example) and SECA taxes.

Thus, our estimate of the amount of the increase in SECA taxes over FICA taxes may be understated if all officer compensation was not paid to the single shareholder of an S corporation, to the extent that decreasing the amount of officer compensation decreases the amounts we considered subject to FICA taxation and concurrently increases the amounts we should have considered subject to SECA taxation. Approximately 85 percent of the SECA tax increases we computed were related to single-shareholder S corporations. Allocating no officer compensation to the shareholders would add 44.9 percent to the tax increases we computed.

**Implications for majority-owned S corporations:** For multiple-shareholder S corporations in which 1 shareholder owns more than 50 percent of the stock (and thus controls the S corporation's decision making), we allocated officer compensation to the majority

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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shareholder by applying the shareholder's percentage of ownership to the total amount of officer compensation paid by the S corporation. The results from allocating too much officer compensation to the majority shareholder would mirror those described for single-shareholder S corporations. That is, if we assigned too much officer compensation to the majority shareholder, it would cause the SECA tax increases we computed to be understated.

However, if more officer compensation was paid to the majority shareholder than we allocated, the difference between the FICA taxes and SECA taxes we computed may be overstated to the extent that increasing the amount of officer compensation increases the amounts we should have considered subject to FICA taxation and decreases the amounts we considered subject to SECA taxation. Approximately 15 percent of the SECA tax increases we computed were related to majority shareholders in multiple-shareholder S corporations. Allocating all officer compensation to the majority shareholders would reduce the SECA increases we computed for these taxpayers by 10.1 percent. Allocating no officer compensation to the majority shareholders would add 60.1 percent to the tax increases we computed.

In summary, if we underestimated the officer compensation attributable to sole owners or majority owners of S corporations, our estimates of the SECA tax increases could be overstated by as much as 1.5 percent. Conversely, if we overestimated the officer compensation attributable to the sole owners or majority owners, our estimates of the SECA tax increases could be understated by as much as 47.2 percent.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

Appendix V

**Management's Response to the Draft Report**



COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D. C. 20224

RECEIVED  
MAY 04 2005

APR 29 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown *KMB*  
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report -- Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations (Audit #200430022)

We have reviewed your draft report and agree that there are compliance issues regarding the payment of sufficient wages to S corporation officers. We also agree that, statutorily, there are differences between the employment tax liabilities of sole proprietorships and single-shareholder S corporations.

However, we do not agree with your basic diagnosis of the cause of the compliance problems and, accordingly, we do not agree with your report or your resulting recommendations. Your report implies that all single-shareholder S corporations are employment tax shelters. We believe this implication is overstated.

Although most closely-held businesses report payment of a reasonable wage to their shareholders who perform services as employees of the corporation, properly establishing reasonable compensation for any shareholder actively operating a corporate business is a continuing challenge. To combat the concern that some S corporations may be underreporting their officer compensation, the IRS developed a Compliance Initiative Project (CIP) that uses filters to identify returns for audit that appear to have this issue. As the project progresses, we are refining these filters to improve our selection criteria.

In addition, we have made significant outreach efforts to ensure S corporations are aware of the requirement to treat reasonable compensation to S corporation officers as wages for employment tax purposes. When a taxpayer elects and receives approval for S corporation status, we mail a letter to the taxpayer regarding employment tax obligations. The issue of the payment of reasonable compensation to S corporation officers was also a point of discussion at the IRS Tax Forums last year. The IRS website ([www.irs.gov](http://www.irs.gov)) provides the public with information about this issue, devoting a page to Revenue Ruling 59-221 and the reasonable compensation issue. On another page of the IRS website, we provide information that distinguishes compensation to a corporate officer from shareholder loans or other payments made to officers. IRS

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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Publication 15, Employer's Tax Guide (Circular E), provides comprehensive information on employment tax issues and addresses officer compensation.

Determining reasonable compensation for any S corporation is a case-by-case facts-and-circumstances issue. Accordingly, we appreciate your recognition that resource limitations may hinder our ability to address our compliance concerns through enforcement and outreach activity, and your general view that changes in the underlying law may be advisable.

Under current law, business owners have different employment tax liabilities depending on the type of business entity (e.g. sole proprietorship, partnership, S corporation). An individual running a sole proprietorship owes Self-Employment Contributions Act (SECA) tax on his net income from the operation of a trade or business. A general partner in a partnership owes SECA tax on his distributive share of the partnership's income or loss. A limited partner in a partnership owes SECA tax on guaranteed payments received for services performed for the partnership. A shareholder officer in an S corporation owes Federal Insurance Contributions Act (FICA) tax on his compensation for services. The issue is how best to determine reasonable compensation for services for application of the FICA tax. Revenue Ruling 59-221 reflects the longstanding rule embedded in the Code and case law that a corporation and its shareholders are separate taxable entities. Thus, while Revenue Ruling 59-221 confirms that SECA tax does not apply to S corporation shareholders, the statutory and judicial laws that form the basis for Revenue Ruling 59-221 are still the law today. Accordingly, we disagree that revocation of the revenue ruling or promulgation of regulations would change the fundamental application of employment tax law to S corporations.

While we agree that our ability to address the compliance issue of whether an S corporation reports reasonable compensation may be furthered with appropriate legislation, the recommendation to subject to employment tax "all ordinary operating gains of an S corporation that accrue to a shareholder" is not consistent with the principles underlying the employment tax statutes. The intent of both SECA and FICA taxes is to fund the accrual of social security benefits earned generally in connection with the performance of services. Your recommendation requires no services to be performed for the S corporation by the shareholder to generate liability for self-employment tax.

Your report is also based on the premise that like entities should have similar treatment and it presumes S corporations are most like sole proprietorships that file Form 1040, Schedule C, Profit or Loss From Business. Your report does not discuss the fact that the current regime for self-employment taxes for S corporations does not match the self-employment tax rules for partnerships, although both are flow-through entities, which are usually managed by their owners. Your report also does not compare the treatment

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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of S corporations and their shareholders to the treatment of limited liability companies (LLCs) and their members or business trusts and trustees/beneficiaries performing services for the trusts. Furthermore, the recommendation does not consider whether the employment tax treatment of S corporations can effectively be addressed without also addressing the employment tax treatment of these other flow-through entities. Your recommendations also do not consider the similarity between S corporations and C corporations.

By contrast, as referenced in your report, the Joint Committee on Taxation (JCT) has published a recent report, Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05) which recognizes the employment tax differences among the types of business entities and provides for a more appropriate remedy to the compliance issues we are facing. The JCT proposal takes into consideration partnerships and LLCs that were not addressed by your report and brings into play the concept of material participation (labor services versus capital profits). We believe a global approach to all flow-through entities would minimize disparate employment tax treatment between various entity types.

There are also administrative and taxpayer burdens that must be considered. Your recommendation suggests that certain S corporation shareholders will be required to pay both FICA tax on their wages as officers and SECA tax on their distributive shares. This proposal could create a perception of double taxation, and result in the individual being employed and self-employed with respect to the same services. Coordinating the FICA and SECA taxes under these circumstances would impose additional administrative and recordkeeping burdens on the S corporation and its shareholders, and complicate enforcement by the IRS. Through your use of the rules of attribution, the draft report did not address whether other minority shareholders would still be required to receive reasonable compensation from the S corporation subject to FICA tax since it would appear they would not be subject to SECA tax under your proposal.

Because we do not agree with your premise that the source of the problem is the revenue ruling and, as we believe it is important to consider the problem in the context of other business entities, we do not agree with the specific recommendations of this report. Therefore, we cannot agree with the outcome measures. We also have concerns with your calculation of the outcome measures. The calculation does not take into account that some taxpayers may react to implementation of the proposal by converting S corporations to another entity (such as a C corporation or a LLC). Your report also assumes the S corporation shareholder has no other self-employment income (or FICA tax wages) and does not account for an offset to self-employment taxes for any S corporation that will reflect an ordinary loss.

While most taxpayers try to be compliant, we will continue our initiatives to identify such employment tax issues for S corporations that do not reflect reasonable compensation.

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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We will continue our outreach efforts to communicate all employment tax provisions as they pertain to each tax entity. As appropriate, we will work with Treasury in furtherance of legislation that would resolve the issues.

Our comments to the recommendations are as follows:

**RECOMMENDATION 1**

The IRS Commissioner should inform the Assistant Secretary for Tax Policy of the detrimental effects discussed in this report of Revenue Ruling 59-221 that was issued under the historically inaccurate assumption that most S corporations would involve multiple shareholders.

**CORRECTIVE ACTION**

We do not agree with this recommendation for the reasons stated in our response. We disagree that Revenue Ruling 59-221 is the cause of the inequities reflected in your report. The issue is not with Revenue Ruling 59-221. In fact, the statutory and judicial laws that form the basis for Revenue Ruling 59-221 are still the law today. Under current law for S corporations, the issue is how best to determine "reasonable compensation" for application of the FICA tax.

**Implementation Date**

N/A

**Responsible Official(s)**

N/A

**Corrective Action Monitoring Plan**

N/A

**RECOMMENDATION 2**

The IRS Commissioner should consult with the Assistant Secretary for Tax Policy regarding whether the detrimental effects of Revenue Ruling 59-221 should be reversed through the issuance of new regulations or through drafting of new legislation, either of which should subject all ordinary operating gains of an S corporation that accrue to a shareholder (including the shareholder's spouse and dependent children) holding more than 50 percent of the stock in the S corporation to employment taxes.

**CORRECTIVE ACTION**

We do not agree with this recommendation for the reasons stated in our response. New regulations would not affect the fundamental application of employment taxes to S corporations. A recommendation to discuss legislative changes to simply subject to employment tax "all ordinary operating gains of an S corporation that accrue to a shareholder" is not consistent with the principles underlying the employment tax statutes

**Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations**

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in connection with the performance of services. Nor does it properly recognize the administrative and taxpayer burdens that this legislation may cause or consider the application of employment taxes to other flow-through entities. However, as stated previously, the IRS will continue its outreach efforts to communicate all employment tax provisions as they pertain to each tax entity. As appropriate, we will work with Treasury in furtherance of legislation that would resolve the issues, in the best interest of tax administration.

**Implementation Date**

N/A

**Responsible Official(s)**

N/A

**Corrective Action Monitoring Plan**

N/A

If you have any questions, please call me at (202) 622-0600 or Steve Burgess, Director Examination, Small Business/Self-Employed Division, at (202) 283-6955.

# **CBO TESTIMONY**

**Statement of  
Douglas Holtz-Eakin  
Director**

**Options for Social Security:  
Budgetary and Distributional Impacts**

**before the  
Committee on Finance  
United States Senate**

**May 25, 2005**

*This statement is embargoed until 10 a.m. (EDT) on  
Wednesday, May 25, 2005. The contents may not be  
published, transmitted, or otherwise communicated  
by any print, broadcast, or electronic media before  
that time.*



**CONGRESSIONAL BUDGET OFFICE  
SECOND AND D STREETS, S.W.  
WASHINGTON, D.C. 20515**

Mr. Chairman, Senator Baucus, and Members of the Committee, the Congressional Budget Office (CBO) appreciates the opportunity to appear before you to discuss the budgetary and distributional implications of various options for slowing the growth of Social Security benefits.

As you know, Social Security is the single largest federal program. In 2004, the Social Security system took in \$569 billion in tax revenue and paid out \$493 billion in benefits. The program provided benefits to more than 47 million people—about two-thirds of them retired workers and the rest disabled workers, survivors of deceased workers, workers' spouses, and minor children.

Although today the program takes in more revenue than it spends, that situation will not continue once large numbers of baby boomers begin claiming retirement benefits. In coming years, the Social Security system will face mounting financial pressures as its outlays start to grow much faster than its revenue. CBO projects that scheduled Social Security outlays (those implied by the current benefit formula) will rise from 4.3 percent of gross domestic product (GDP) this year to 6.5 percent in 2050. Revenue, however, is scheduled to remain at 4.9 percent of GDP.

That financial outlook has prompted discussion of various ways to make the Social Security system solvent. My testimony today focuses on the spending side of the program, as requested by the Chairman. I will discuss several options for curtailing the growth of outlays and compare their effects on the system's finances and on different types of beneficiaries. CBO has also prepared a more comprehensive menu of options for changing scheduled benefits or revenue, which is included as an attachment at the end of this statement.

### **The Financial Outlook for Social Security**

The next decade will see the beginning of a significant, long-lasting shift in the age profile of the U.S. population. Over the next 50 years, the number of people ages 65 and older will more than double, while the number of adults under age 65 will grow by less than 20 percent. That shift reflects demographic trends that have been evident for many years and that are expected to continue, such as the aging of the baby-boom generation, increases in life spans, and a fertility rate below that needed to replace the population.

Those trends imply that the number of workers per Social Security beneficiary will drop significantly, from 3.3 this year to 2.0 in 2050. Because Social Security depends on revenue from current workers to finance benefits, that demographic shift will have a profound impact on the system's finances. Without changes in tax or spending policies, expenditures will start to rise faster than revenue, pushing up federal debt and slowing the growth of the economy.

As requested by the Chairman, my testimony examines the outlook for Social Security using the same long-term economic and demographic assumptions used in the March 2005 report of the Social Security trustees. The differences between the projections of annual Social Security spending and revenue presented here and the ones that CBO released in March 2005 are small and occur largely because CBO's assumptions about future wage growth and interest rates are slightly higher than the trustees'.

### **The Financing Perspective**

In 2009, the Social Security surplus—the amount by which the program's dedicated revenue in a year exceeds the benefits paid in that year—will start to diminish. In 2019, that surplus will disappear, and outlays for benefits will begin to exceed the system's annual revenue, CBO projects using the trustees' long-term economic assumptions (see Figure 1). To pay full benefits, the Social Security system will eventually have to rely on interest on government bonds held in its trust funds—and ultimately, on the redemption of those bonds. In the absence of other changes, bonds can continue to be redeemed until the trust funds are exhausted, which will occur in 2044, CBO projects. But where will the Treasury find the money to pay for the bonds? Will policymakers cut back other spending in the budget? Will they raise taxes? Or will they borrow more?

Once the trust funds are exhausted, the Social Security Administration will no longer have the legal authority to pay full benefits. As a result, it will have to reduce payments to beneficiaries to match the amount of revenue coming into the system each year. Although the exact size of that reduction is uncertain, benefits would probably have to be cut—both for current recipients and for new beneficiaries—by about 25 percent to match the system's available revenue.

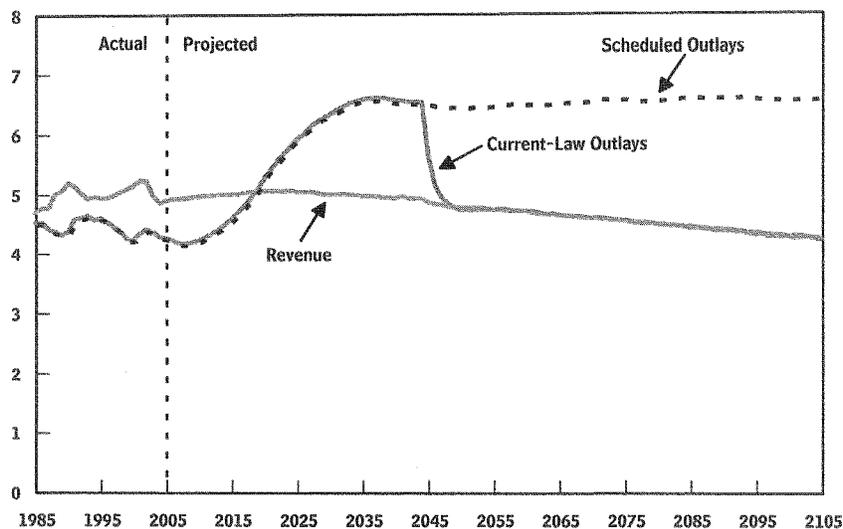
The key message from those numbers is that with benefits reduced annually to equal revenue, as they will be under current law when the trust funds run out, some form of the Social Security program can be sustained forever. Of course, many people would not consider a sudden 25 percent cut in benefits to be desirable policy. In addition, the budgetary demands of bridging the gap between spending and revenue in the years before that cut could prove onerous. But Social Security is sustainable from a narrow programmatic perspective. What is not sustainable is continuing to provide the present level of scheduled benefits given the present financing.

### **The Budgetary and Economic Perspective**

CBO's projections offer some guidance about the potential impact of those developments on the budget. Under the trustees' long-term assumptions, the Social Security surplus (excluding interest on bonds in the trust funds) will reach about \$100 billion in 2007. By 2025, however, the surplus will have turned into a deficit

**Figure 1.****Social Security Revenue and Outlays as a Share of GDP**

(Percentage of GDP)



Source: Congressional Budget Office.

Notes: This figure is based on a simulation from CBO's long-term model using the Social Security trustees' 2005 intermediate demographic assumptions and long-term economic assumptions and CBO's January 2005 10-year economic assumptions.

Revenue includes payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include Social Security benefits and administrative costs. Under current law, outlays will begin to exceed revenue in 2019; starting in 2045, the program will no longer be able to pay the full amount of scheduled benefits.

of roughly \$100 billion (in 2005 dollars). That \$200 billion swing will represent a significant challenge for the budget as a whole, especially in light of the current budget deficit.

The demand on the budget from Social Security will take place at the same time as—but be eclipsed by—the demand from Medicare and Medicaid. Currently, outlays for Social Security benefits are slightly more than 4 percent of GDP, as is federal spending on Medicare and Medicaid combined. But whereas Social Security outlays are projected to grow to 6.5 percent of GDP by 2050, spending on the two health programs could reach a total of 20 percent of GDP if current trends in health care costs continue.

Without changes in policy, therefore, federal spending is likely to increase sharply in coming decades, widening the gap between outlays and revenues and expanding the amount of federal borrowing. The resulting rise in government debt could seriously harm the economy. It could crowd out private capital formation, and although its impact on capital accumulation could be muted by borrowing from abroad, foreign borrowing is no panacea. The debt owed to foreigners would still have to be serviced. In the end, federal debt would reduce the disposable income of U.S. residents and erode future living standards.

### **The Structure of the Current Social Security System**

Social Security benefits are based on earnings during a person's working years. Workers with higher lifetime earnings receive higher benefits, as do their dependents and survivors. However, the benefit formula is structured to redistribute income: benefits replace a smaller portion of earnings for higher earners and a larger portion for lower earners.

#### **The Benefit Formula**

Benefits for retired or disabled workers are based on the average level of workers' taxable earnings over their working lifetime (their average indexed monthly earnings, or AIME). For retired workers, the AIME is based on the highest 35 years of earnings on which they paid Social Security taxes (up to the taxable maximum, \$90,000 in 2005), with some adjustments. Earnings before age 60 are indexed to compensate both for past inflation and for real (after-inflation) growth in wages. For disabled workers and the survivors of deceased workers, the AIME can be based on a shorter period.

A progressive formula is applied to a worker's average indexed monthly earnings to calculate his or her primary insurance amount (PIA). The PIA is the monthly amount payable either to a worker who begins receiving Social Security retirement benefits at the age at which he or she is eligible for full benefits or to a disabled worker. The formula is designed to ensure that initial Social Security benefits replace a larger proportion of preretirement earnings for people with low average earnings than for those with higher earnings. For workers who turn 65 this year, the formula is:

$$\begin{aligned} \text{PIA} = & (90 \text{ percent of the first } \$592 \text{ of the AIME}) + \\ & (32 \text{ percent of the AIME between } \$592 \text{ and } \$3,567) + \\ & (15 \text{ percent of the AIME over } \$3,567) \end{aligned}$$

The dollar thresholds at which changes occur in the percentage of the AIME replaced by the PIA are known as "bend points" (see Figure 2). The percentages themselves are known as "replacement factors."

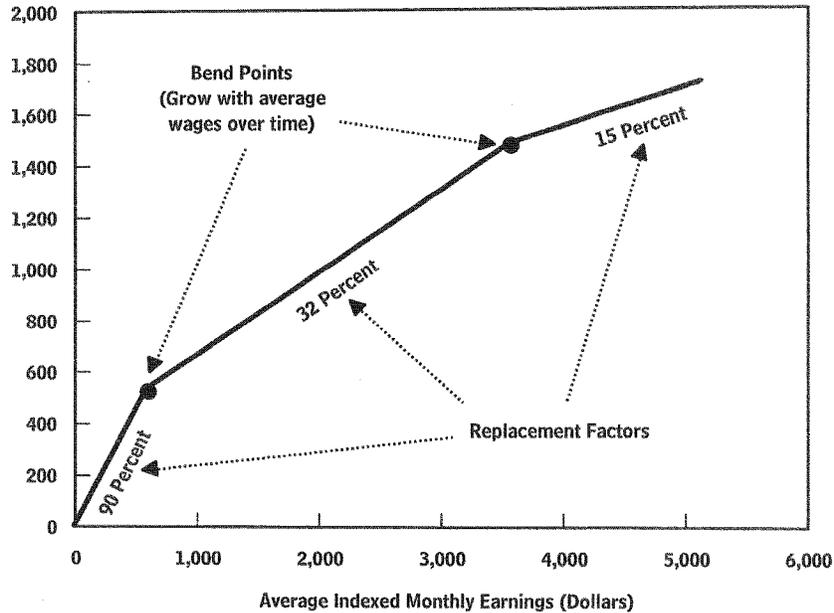
**Figure 2.**


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**Primary Insurance Amount Under Current Law  
(For workers who turn 65 in 2005)**


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(Primary insurance amount in dollars)



Source: Congressional Budget Office based on data from the Social Security Administration.

Note: The bend points shown here are those in 2002, the first year in which workers turning 65 in 2005 were eligible to collect retirement benefits.

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Each year, the bend points are increased to match growth in average annual earnings for the labor force as a whole. If earnings growth is roughly constant, benefits for new recipients rise at approximately the same rate as average earnings. So long as the system pays scheduled benefits, Social Security benefits will replace the same portion of earnings for future generations (at the normal retirement age) as they do for today's beneficiaries. But because average earnings typically grow faster than prices do, the purchasing power of those benefits will be higher than that of benefits paid today, allowing beneficiaries to share in future increases in workers' living standards. Once the trust funds are exhausted, however, those replacement rates will fall, under current law (see the lower lines of Figure 3).

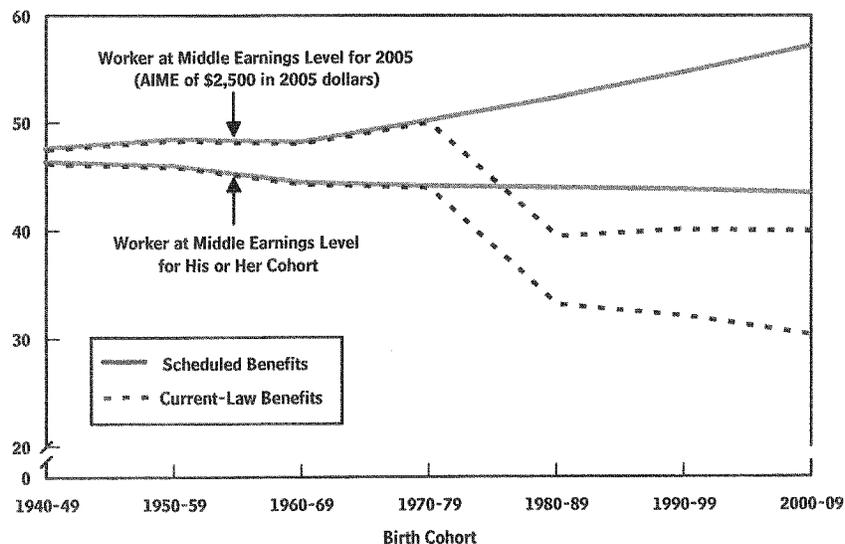
**Figure 3.**


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**Projected Replacement Rate for Retired Workers  
at Age 65**


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(Benefits as a percentage of average indexed monthly earnings)



Source: Congressional Budget Office.

Notes: This figure is based on a simulation from CBO's long-term model using the Social Security trustees' 2005 intermediate demographic assumptions and long-term economic assumptions and CBO's January 2005 10-year economic assumptions.

The replacement rate is the ratio of the benefits that a worker would receive upon claiming them at age 65 to the worker's average indexed monthly earnings (AIME), both computed using earnings through age 61. Under current law, scheduled benefits cannot be paid starting in 2045.

Another perspective on trends in replacement rates comes from considering how benefits change over time for workers with the same level of real earnings. To illustrate that perspective, consider someone making \$2,500 a month. That level of income is currently around the middle of the earnings distribution. But in 2050, someone earning \$2,500 a month (adjusted for inflation) will earn less than two-thirds of workers, even though he or she will have the same purchasing power as a median worker today. Because the Social Security benefit formula is progressive and indexed to wages—through both the indexation of earnings before age 60 in calculating the AIME and the indexation of the bend points in the PIA formula—benefits will replace a larger portion of earnings for future workers at that earn-

ings level (see the top line in Figure 3). Again, exhaustion of the trust funds would lead to lower replacement rates.

#### **Retirement Age**

Under current law, the age at which a worker becomes eligible for full Social Security retirement benefits—the normal retirement age (NRA)—depends on the worker's year of birth. For people born before 1938, the NRA is 65. For slightly younger workers, it increases by two months per birth year, reaching 66 for people born in 1943. The NRA remains at 66 for workers born between 1944 and 1954 and then increases in two-month increments again, reaching 67 for people born in 1960 or later.

Workers can begin receiving retirement benefits before their NRA—as early as age 62—but their monthly benefits will be permanently lower than if they had waited until the NRA to claim benefits. Likewise, if workers delay receipt until they are older than the NRA, their monthly benefits will be higher. Those adjustments are intended to be “actuarially fair,” so that the total value of benefits received over a lifetime will be approximately equal regardless of when a worker first claims benefits.

#### **Cost-of-Living Adjustment**

At the end of each year, the Social Security Administration adjusts existing benefits by the amount of any increase in the consumer price index. For example, the cost-of-living adjustment of 2.7 percent that took effect in December 2004 reflected the increase in the consumer price index for urban wage earners and clerical workers that occurred between the third quarter of 2003 and the third quarter of 2004.

### **Policy Options for Slowing the Growth of Outlays**

As discussed earlier, in the absence of policy changes, CBO expects the Social Security trust funds to be depleted in 2044, under the trustees' long-term assumptions. After that, the program would no longer have the legal authority to pay full benefits. Spending would have to be reduced to match available revenue, which could require across-the-board cuts of 25 percent in benefits. Those reductions would affect not only newly eligible beneficiaries but also existing Social Security recipients of all ages.

#### **Providing the Authority for Full Scheduled Benefits**

Those benefit cuts could be avoided by giving the Social Security program the legal authority to borrow money in the event of trust-fund exhaustion. That option, however, would not address the broader budgetary and economic issues stemming from the fiscal imbalances in the Social Security system. Borrowing

money to pay benefits would not be a sustainable option in the long run. By contributing to the growth of federal debt, it could have a corrosive effect on economic growth and could eventually lead to a sustained economic contraction. Repaying that debt would ultimately require cuts in spending or higher taxes somewhere in the budget.

Cuts in benefits could also be avoided by increasing taxes or reducing other federal spending and directing the savings to Social Security. Although such approaches would address Social Security's fiscal imbalances, some types of tax increases could risk slowing economic growth by discouraging work and saving, and reducing other spending could be difficult in light of the projected rise in federal outlays for health care.

### **Improving Social Security's Financial Balance**

A variety of proposals have been advanced for restoring balance to the Social Security system. As noted above, CBO has prepared a menu of illustrative options for altering scheduled benefits or revenue. That menu—which is attached to this statement—includes the effects of the options on Social Security's finances as well as on the taxes paid and benefits received by people in different income groups and birth cohorts. The menu is intended to be representative of the types of changes that could be made to Social Security, but it is far from exhaustive. For example, it does not include options to introduce individual accounts, because the effects of such options are too complex to be shown clearly in the limited space available in the menu. (CBO has analyzed proposals for individual accounts in other publications.)<sup>1</sup> Moreover, it must be emphasized that various changes would be likely to interact with each other, so the net effect of multiple changes would be different from the sum of the individual effects.

This testimony examines the budgetary and distributional implications of three options to slow the growth of benefits: the first is taken directly from the attached menu, the second is a variation on a menu option, and the third is a combination of two menu options. All three would reduce scheduled benefits for people who first become eligible for benefits in 2012, including retired and disabled workers and their dependents and survivors. All of the options would keep the Social Security system solvent for at least the next 100 years.

**Descriptions of the Options.** The first approach considered here is the provision for price indexing of initial benefit awards advanced by the President's Commission to Strengthen Social Security (option 1.1 in the attached menu). Under that

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1. See, for example, Congressional Budget Office, *Long-Term Analysis of Plan 2 of the President's Commission to Strengthen Social Security* (July 21, 2004), and *Long-Term Analysis of H.R. 3821, the Bipartisan Retirement Security Act of 2004* (July 21, 2004).

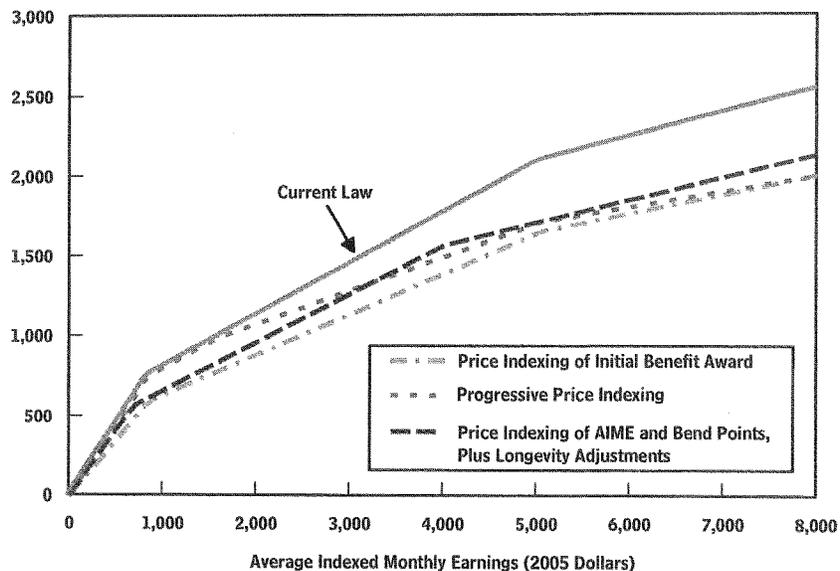
**Figure 4.**


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**Primary Insurance Amount Under Various Options**  
**(For workers who turn 65 in 2035)**


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(Primary insurance amount in 2005 dollars)



Source: Congressional Budget Office.

Notes: This figure is based on a simulation from CBO's long-term model using the Social Security trustees' 2005 intermediate demographic assumptions and long-term economic assumptions and CBO's January 2005 10-year economic assumptions.

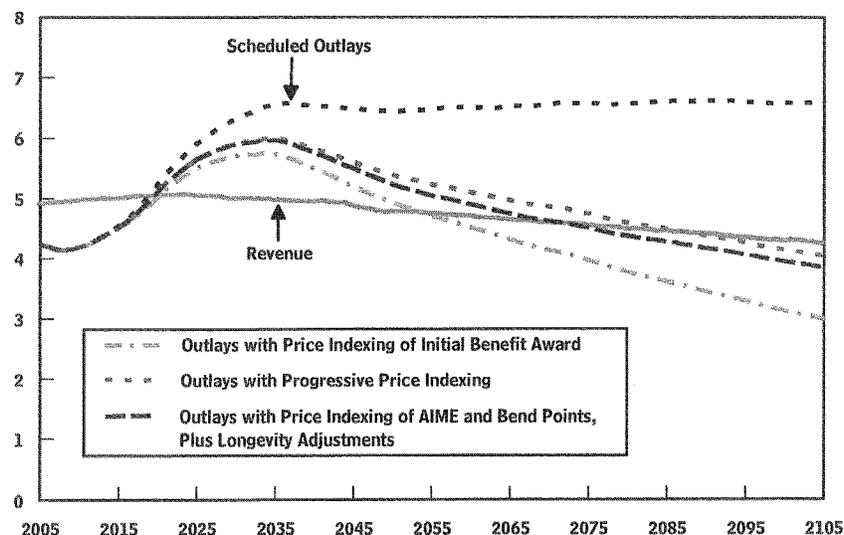
The bend points shown here are those in 2032, the first year in which workers turning 65 in 2035 will be eligible to collect retirement benefits under current law.

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option, the three replacement factors in the current PIA formula would be lowered each year to offset the effects of real wage growth (see Figure 4, which shows the effects of the options in 2035). The AIME and the bend points would continue to be indexed to wages. As a result, benefits would generally grow with inflation, so future beneficiaries would have the same purchasing power as today's beneficiaries, on average. Relative to scheduled benefits, payments to new beneficiaries would decline by one-quarter over 26 years and by one-half over 63 years, assuming that real wages grew by 1.1 percent a year, on average. Initially, Social Security outlays would increase relative to GDP, but in later years, they would decline

**Figure 5.**  
**Social Security Revenue and Outlays as a Share of GDP**  
**Under Various Options**

(Percentage of GDP)



Source: Congressional Budget Office.

Notes: This figure is based on a simulation from CBO's long-term model using the Social Security trustees' 2005 intermediate demographic assumptions and long-term economic assumptions and CBO's January 2005 10-year economic assumptions.

Revenue includes payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include Social Security benefits and administrative costs. Under current law, outlays will begin to exceed revenue in 2019; starting in 2045, the program will no longer be able to pay the full amount of scheduled benefits. Under the alternative options, outlays will start to exceed revenue in 2020. All three of the options begin in 2012, and under each, scheduled benefits are always payable.

as a share of GDP and fall substantially below the program's dedicated revenue (see Figure 5).

A variant of that type of price indexing is known as progressive price indexing. In the version of progressive price indexing that CBO analyzed (a variation of menu option 1.2), the replacement factors for workers with the highest earnings—those who earned the taxable maximum or more for at least 35 years—would be reduced to the same extent as under the previous option. For most workers below that earnings level, however, the reductions in replacement factors would be

smaller, with the extent of the reduction correlated with earnings, so that workers with higher earnings would have their replacement factors reduced the most. Beneficiaries in the lowest 25 percent of the earnings distribution would not be directly affected by this policy change (see Figure 4). After 95 years, new beneficiaries with AIMEs above \$3,150 (in 2005 dollars) would all receive the same benefit. Because fewer beneficiaries would be affected under this option and because their benefit reductions would be smaller, total outlays would be higher than under the previous price-indexing option, but they would fall below revenue around 2090 (see Figure 5).

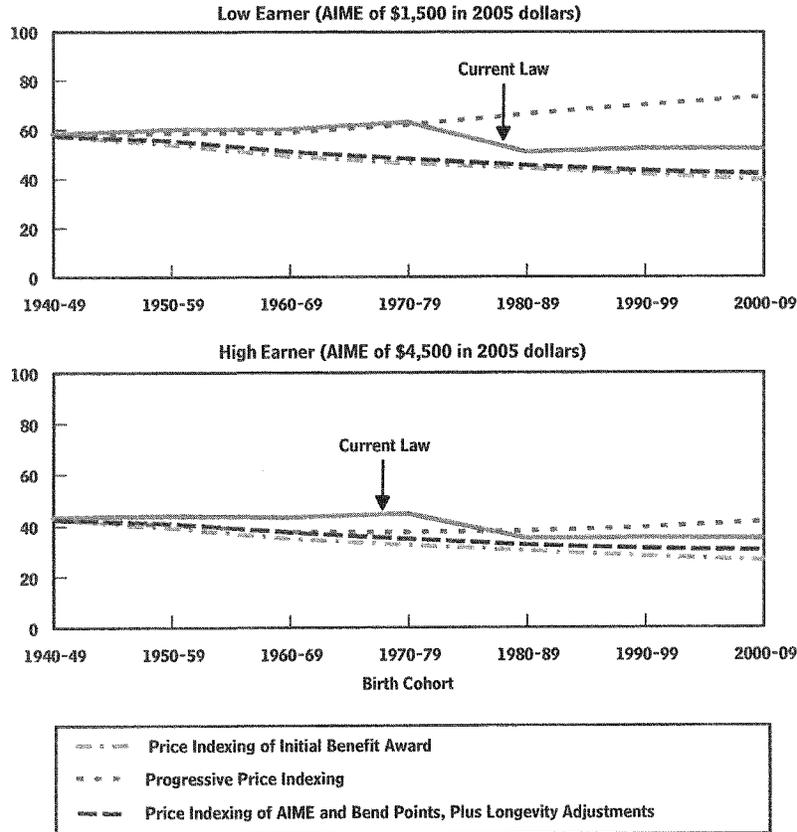
The third option that CBO examined (a combination of menu options 1.3 and 1.6) would change the indexing of bend points and of the AIME and would adjust benefits for increases in longevity. Under this approach, bend points would grow with prices instead of with average wages, as they do under current law. Over time, the bend points would shift to lower levels of earnings, and average replacement rates would decline relative to those specified by current law (see Figure 4). In addition, in the calculation of the AIME, earnings would be indexed to prices instead of to wages. Finally, this option would adjust the benefit formula to offset increases in life expectancy in order to ensure that total lifetime benefits did not grow as life spans increased. (The longevity adjustments would apply only to retirement benefits.) All three of those changes would reduce scheduled benefits. Outlays would be higher than under price indexing of initial benefits but would fall below dedicated revenue after 2075 (see Figure 5).

Under all three options, the PIA formula would change annually. Before 2035, the proposed formulas would be closer to current law than shown in Figure 4, whereas in later years they would be lower.

**Distributional Effects.** The effects of those options on different groups of workers—younger and older, lower-earning and higher-earning—can be examined by estimating how much of a group's earnings the proposed benefits would replace. Under all of the options, as under current law, higher earnings would result in higher benefits in dollar terms, but the percentage of earnings replaced would be greater for lower earners. The three options differ in the degree to which they would affect replacement rates.

As discussed earlier, workers can be classified by earnings levels in various ways. One way is to group people with a specific real earnings level, such as \$1,500 a month. Someone at that earnings level always has the same purchasing power but will fall lower in the earnings distribution over time. Alternatively, workers can be grouped by relative earnings—for example, the top 20 percent or bottom 20 percent of earners in each cohort. (For projections of replacement rates by birth cohort using those two classifications, see Figures 6 and 7.)

**Figure 6.**  
**Projected Replacement Rate for Retired Low and High Earners at Age 65 Under Various Options**  
 (Benefits as a percentage of average indexed monthly earnings)

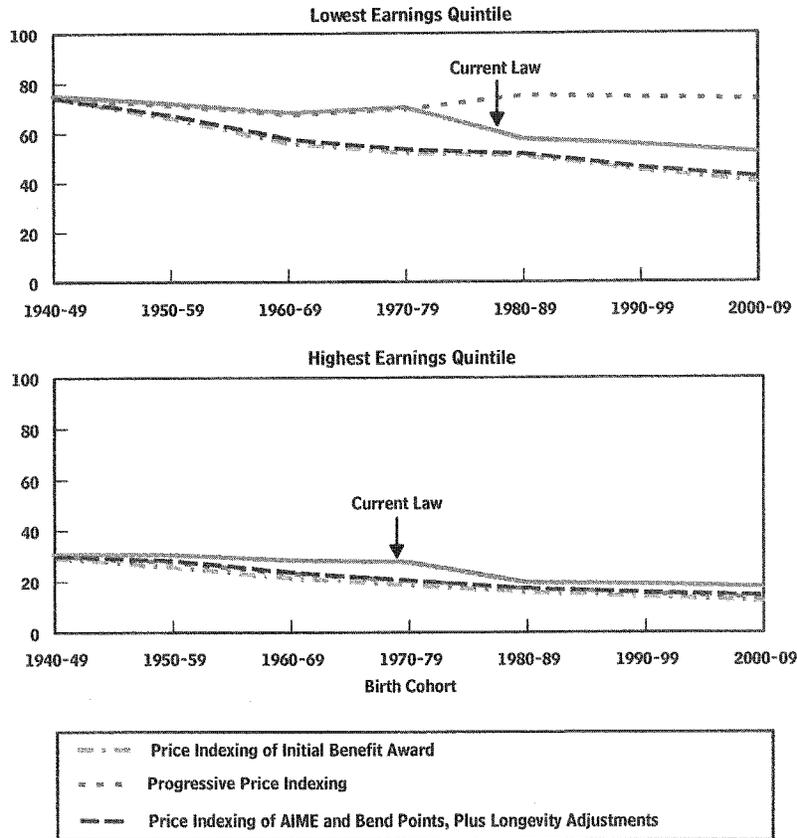


Source: Congressional Budget Office.

Notes: This figure is based on a simulation from CBO's long-term model using the Social Security trustees' 2005 intermediate demographic assumptions and long-term economic assumptions and CBO's January 2005 10-year economic assumptions.

The replacement rate is the ratio of the benefits that a worker would receive upon claiming them at age 65 to the worker's average indexed monthly earnings (AIME), both computed using earnings through age 61. Under current law, scheduled benefits cannot be paid starting in 2045. Under the alternative options, scheduled benefits are always payable.

**Figure 7.**  
**Projected Replacement Rate for Retired Workers**  
**at Age 65, by Earnings Quintile, Under Various Options**  
 (Benefits as a percentage of average indexed monthly earnings)



Source: Congressional Budget Office.

Notes: This figure is based on a simulation from CBO's long-term model using the Social Security trustees' 2005 intermediate demographic assumptions and long-term economic assumptions and CBO's January 2005 10-year economic assumptions.

The replacement rate is the ratio of the benefits that a worker would receive upon claiming them at age 65 to the worker's average indexed monthly earnings (AIME), both computed using earnings through age 61. Under current law, scheduled benefits cannot be paid starting in 2045. Under the alternative options, scheduled benefits are always payable.

Under current law, people who died before 2044 would not be affected by the automatic benefit reductions that would occur upon trust-fund exhaustion. For the most part, their benefits would be lower under all three options, although benefits would be unchanged for lower earners in those cohorts under progressive price indexing.

Of the three options, price indexing of initial benefits would produce the largest change for future beneficiaries, especially later cohorts. Moreover, because that policy would involve an across-the-board cut in initial benefits, it would affect the benefits of all earnings groups by the same percentage.

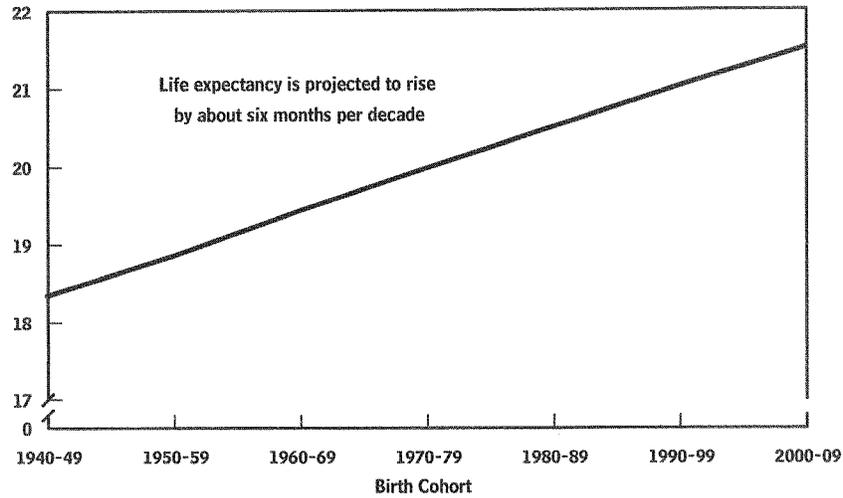
Under progressive price indexing, benefits for high earners would be lower than under current law. But unlike under current law, those benefit reductions would allow the trust funds to remain solvent. As a result, workers in later cohorts would be spared the across-the-board benefit cuts that would occur when the trust funds were exhausted. For lower earners in those cohorts, benefits would be higher than under current law.

Under the third option, price indexing of the AIME and bend points plus longevity adjustments, replacement rates would be lower than under current law for all income groups. However, those rates would be slightly higher than under price indexing of initial benefits.

The replacement rates presented here consider only retired-worker benefits. Moreover, they do not account for expected increases in longevity (see Figure 8), which will allow future cohorts to claim benefits for a longer period of time. To address those issues, CBO estimated how the policy options discussed here would affect the lifetime Social Security benefits of people in different earnings levels and birth cohorts (see Figure 9). On average, real scheduled lifetime benefits for the cohort born from 2000 to 2009 will be more than twice as high as those for the 1940s cohort, CBO projects. Although lifetime benefits and replacement rates are different measures, both convey the same basic message about how these policy changes would affect various beneficiaries.

**Figure 8.****Life Expectancy at Age 65**

(Remaining years of life)

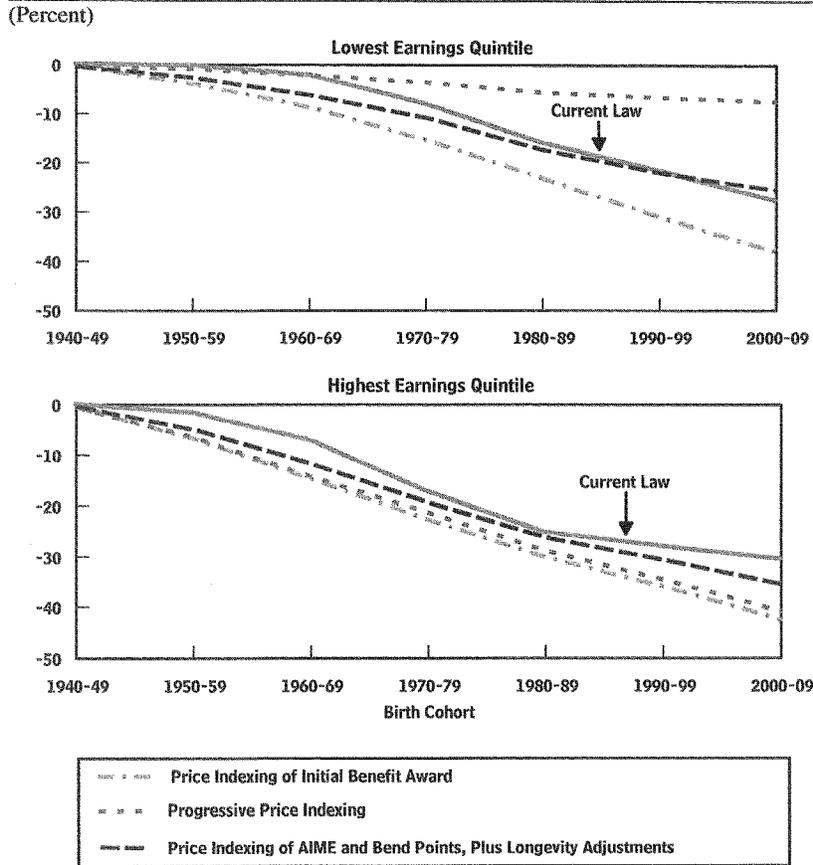


Source: Congressional Budget Office.

Notes: This figure is based on a simulation from CBO's long-term model using the Social Security trustees' 2005 intermediate demographic assumptions and long-term economic assumptions and CBO's January 2005 10-year economic assumptions.

Cohort life expectancies are calculated using death rates from the series of years in which a person will reach each succeeding age if he or she survives.

**Figure 9.**  
**Percentage Change in Lifetime Benefits Relative to Scheduled Benefits, by Earnings Quintile, Under Various Options**



Source: Congressional Budget Office.

Notes: This figure is based on a simulation from CBO's long-term model using the Social Security trustees' 2005 intermediate demographic assumptions and long-term economic assumptions and CBO's January 2005 10-year economic assumptions, including only people who live to at least age 45.

Lifetime benefits are the present value of benefits received by an individual over his or her lifetime, including Old-Age and Disability worker benefits and Old-Age Spouse and Survivor benefits financed by dedicated payroll taxes, net of income taxes on benefits credited to the Social Security trust funds. Under current law, scheduled benefits cannot be paid starting in 2045; under the alternative options, scheduled benefits are always payable.

## **Projected Effects of Various Provisions on Social Security's Financial and Distributional Outcomes**

### **Congressional Budget Office**

The attached tables present projected changes to *financial* and *distributional* outcomes under various provisions. In keeping with CBO's mandate to provide objective, nonpartisan analysis, this document makes no recommendations.

Outcomes presented here are based on the Social Security trustees' 2005 demographic and long-run economic assumptions and CBO's January 2005 short-run economic assumptions, which differ from the outcomes released in March 2005 that were based on the Social Security trustees' 2004 demographic assumptions and CBO's January 2005 short- and long-run economic assumptions.

These provisions are stylized concepts of various individual changes to Social Security. The results may be very sensitive to the exact implementation of any particular provision. If provisions are combined, significant interactions in the presented changes may occur. If the start date of a provision is delayed, the change in the effects could be disproportionate because of the large shift in demographics occurring over the next 30 years. In particular, trust fund exhaustion dates can be very sensitive to adjustments in provision details. Provisions that change scheduled benefits also change revenues through the income taxation of benefits.

Financial outcomes are presented relative to a scheduled baseline. The scheduled baseline assumes the Social Security trust funds have borrowing authority to pay scheduled benefits after the trust funds have been exhausted. Distributional outcomes are presented relative to both scheduled and current law baselines. The current law baseline assumes that all beneficiaries are subject to an across-the-board cut in benefits so that total projected outlays equal projected revenues once the Social Security trust funds are projected to be exhausted; similar cuts are applied under each provision in any years after the Social Security trust funds are projected to be depleted.

*Financial outcomes* include:

- Revenues as a share of GDP
- Outlays as a share of GDP
- Balances (revenues less outlays) as a share of GDP
- 75-year present value deficit as a share of GDP

- 75-year present value deficit as a share of taxable payroll (75-year actuarial balance)
- Crossover year—revenues from dedicated taxes first fall below outlays
- Exhaustion year—trust funds are projected to be depleted

*Distributional outcomes*, presented for selected 10-year birth cohorts and lifetime household earnings quintiles, include:

- First-year retired worker benefits
- Present value of all lifetime benefits
- Present value of all lifetime payroll taxes

*Provisions* considered include changes to:

1. Indexing of benefits
2. The benefit formula
3. Normal retirement age or actuarial adjustments
4. Cost-of-living adjustments (COLA) for benefits
5. Payroll tax rates or taxable maximum
6. Benefits for low earners
7. Auxiliary benefits

Many other provisions are possible; these tables present the results for one set of various types of changes. However, there are no individual accounts considered here.

The appendix provides more details about how each provision would alter existing Social Security rules.

The analysis does not reflect any considerations of the potential effects on the macroeconomy that may occur under any of the various provisions.

### **Definitions of Key Terms:**

Lifetime Earnings Quintile: Each individual is ranked by his or her lifetime household earnings. Individuals are then divided into five quintiles. The values shown are the averages for the bottom, middle, and top quintiles. (The values for the 2nd and 4th quintiles are not shown.) Lifetime household earnings equal the sum of real earnings over a given person's lifetime if they remain single in all years. In any year an individual is married, the earnings measure for that year is a function of his or her earnings plus his or her spouse's earnings (adjusted for economies of

scale in household consumption). The individual's lifetime earnings is the present value of these annual amounts.

Birth Cohort: Individuals are grouped into 10-year cohorts. The 1960s birth cohort includes those born from 1960 through 1969; the 1980s cohort includes those born from 1980 through 1989; and the 2000s cohort includes those born from 2000 through 2009.

First-Year Benefits for Retired Workers: The average of retired worker benefits that would be received by workers eligible to claim Old-Age Insurance benefits at age 62 who have not yet claimed any other benefit. Benefits are computed assuming that all workers claim benefits at age 65 and are based only on earnings through age 61. Values are net of income taxes paid on benefits and credited to the Social Security trust funds.

Lifetime Benefits: The present value at age 60 of benefits received by an individual over a lifetime, including Old-Age and Disability worker benefits and Old-Age Spouse and Survivor benefits, net of income taxes paid on those benefits and credited to the Social Security trust funds.

Lifetime Payroll Taxes: The present value of both OASDI employer and employee taxes paid over a lifetime; under current law, the tax is 12.4 percent of taxable earnings.

Scheduled Benefits (Table 2) and Current-Law Benefits (Table 3): Under current law, all beneficiaries are subject to an across-the-board cut in benefits such that total projected benefits equal projected revenues once the Social Security trust funds have been exhausted. Similar cuts are applied under each provision in any years after the Social Security trust funds are projected to be depleted.

**Table 1. Summary Measures of Social Security Financial Outcomes Projections Under Scheduled Baseline**

	Revenues, Outlays and Balance (Revenues Less Outlays) as a % of GDP					75 Year PV Deficit as a % of Taxable Payroll		Revenues Fall Below Outlays	Trust Fund Exhaustion Year
	Year					GDP	Taxable Payroll		
	2020	2040	2060	2080	2100				
Revenues	5.04	4.92	4.79	4.58	4.40	5.19	13.94		
Outlays	5.29	6.54	6.61	6.57	6.59	5.82	15.63		
Balance	-0.25	-1.62	-1.72	-1.99	-2.19	-0.63	-1.69	2019	2044

**Changes to Social Security Financial Outcomes Under Various Provisions Projections Under Scheduled Baseline**

	Change in Revenues, Outlays and Balance (Revenues Less Outlays) as a % of GDP					Change in 75 Year PV Deficit as a % of Taxable Payroll		Revenues Fall Below Outlays	Trust Fund Exhaustion Year
	Year					GDP	Taxable Payroll		
	2020	2040	2060	2080	2100				
1.1 Grow initial benefits with prices rather than wages beginning in 2012	Revenues	-0.01	-0.05	-0.10	-0.15	-0.19	-0.05	-0.13	
	Outlays	-0.22	-1.02	-1.97	-2.79	-3.44	-0.93	-2.50	2020*
	Balance	0.21	0.97	1.86	2.64	3.25	0.88	2.37	
1.2 Grow initial benefits slower than wages for top 70% beginning in 2012 ("progressive price indexing")	Revenues	-0.01	-0.03	-0.07	-0.11	-0.13	-0.03	-0.09	
	Outlays	-0.13	-0.66	-1.32	-1.89	-2.30	-0.61	-1.64	2019*
	Balance	0.13	0.62	1.24	1.78	2.17	0.58	1.55	2065
1.3 Price index earnings in AIME formula and bend points in PIA formula beginning in 2012	Revenues	0.00	-0.03	-0.07	-0.10	-0.11	-0.03	-0.08	
	Outlays	-0.10	-0.59	-1.27	-1.76	-2.12	-0.67	-1.53	2019
	Balance	0.10	0.56	1.20	1.67	2.00	0.54	1.45	2067
1.4 Price index earnings in AIME formula beginning in 2012	Revenues	0.00	-0.01	-0.02	-0.02	-0.03	-0.01	-0.02	
	Outlays	-0.01	-0.15	-0.40	-0.46	-0.43	-0.16	-0.42	2019
	Balance	0.01	0.15	0.38	0.43	0.41	0.15	0.40	2048
1.5 Price index bend points in PIA formula beginning in 2012	Revenues	0.00	-0.02	-0.05	-0.07	-0.10	-0.02	-0.05	
	Outlays	-0.09	-0.46	-0.85	-1.40	-1.79	-0.44	-1.18	2019
	Balance	0.09	0.43	0.80	1.33	1.69	0.42	1.12	2053

**1. Changes to Indexing of Benefits**

1.1 Grow initial benefits with prices rather than wages beginning in 2012	Revenues	-0.01	-0.05	-0.10	-0.15	-0.19	-0.05	-0.13	
	Outlays	-0.22	-1.02	-1.97	-2.79	-3.44	-0.93	-2.50	2020*
	Balance	0.21	0.97	1.86	2.64	3.25	0.88	2.37	
1.2 Grow initial benefits slower than wages for top 70% beginning in 2012 ("progressive price indexing")	Revenues	-0.01	-0.03	-0.07	-0.11	-0.13	-0.03	-0.09	
	Outlays	-0.13	-0.66	-1.32	-1.89	-2.30	-0.61	-1.64	2019*
	Balance	0.13	0.62	1.24	1.78	2.17	0.58	1.55	2065
1.3 Price index earnings in AIME formula and bend points in PIA formula beginning in 2012	Revenues	0.00	-0.03	-0.07	-0.10	-0.11	-0.03	-0.08	
	Outlays	-0.10	-0.59	-1.27	-1.76	-2.12	-0.67	-1.53	2019
	Balance	0.10	0.56	1.20	1.67	2.00	0.54	1.45	2067
1.4 Price index earnings in AIME formula beginning in 2012	Revenues	0.00	-0.01	-0.02	-0.02	-0.03	-0.01	-0.02	
	Outlays	-0.01	-0.15	-0.40	-0.46	-0.43	-0.16	-0.42	2019
	Balance	0.01	0.15	0.38	0.43	0.41	0.15	0.40	2048
1.5 Price index bend points in PIA formula beginning in 2012	Revenues	0.00	-0.02	-0.05	-0.07	-0.10	-0.02	-0.05	
	Outlays	-0.09	-0.46	-0.85	-1.40	-1.79	-0.44	-1.18	2019
	Balance	0.09	0.43	0.80	1.33	1.69	0.42	1.12	2053

Changes to Social Security Financial Outcomes Under Various Provisions  
Projections Under Scheduled Baseline

	Change in Revenues, Outlays and Balance (Revenues Less Outlays) as a % of GDP						Revenues Fall Below Outlays	Trust Fund Exhaustion Year
	Change in 75 Year PV Deficit as a % of Payroll							
	2020	2040	2060	2080	2100			
1.6 Longevity index initial benefits beginning in 2012	Revenues	0.00	-0.01	-0.02	-0.03	-0.04	-0.03	2047
	Outlays	-0.03	-0.20	-0.42	-0.60	-0.73	-0.19	
	Balance	0.03	0.19	0.39	0.57	0.69	0.43	
<b>2. Changes to Benefit Formula</b>								
2.1 Reduce all PIA factors by 20% in 2012	Revenues	-0.03	-0.06	-0.06	-0.07	-0.07	-0.04	2108
	Outlays	-0.62	-1.12	-1.23	-1.25	-1.23	-0.81	
	Balance	0.60	1.07	1.16	1.18	1.17	0.76	
2.2 Reduce top two PIA factors from 35% to 20% and from 15% to 10% in 2012	Revenues	-0.03	-0.05	-0.07	-0.07	-0.07	-0.04	None
	Outlays	-0.61	-1.15	-1.27	-1.30	-1.28	-0.82	
	Balance	0.59	1.09	1.20	1.23	1.21	0.78	
2.3 Reduce top PIA factor from 15% to 10% in 2012	Revenues	0.00	0.00	0.00	-0.01	0.00	0.00	2046
	Outlays	-0.05	-0.09	-0.12	-0.13	-0.13	-0.07	
	Balance	0.05	0.09	0.12	0.12	0.12	0.07	
2.4 Reduce all PIA factors by 0.005 annually beginning in 2011	Revenues	0.00	0.02	-0.05	-0.06	-0.11	-0.03	2054
	Outlays	-0.00	-0.06	-0.09	-0.10	-0.10	-0.06	
	Balance	0.00	0.48	0.80	1.32	1.85	1.22	
2.5 Increase AIME calculation years from 35 to 40 phased in 2007-2011	Revenues	-0.01	-0.01	-0.01	-0.01	-0.01	-0.02	2048
	Outlays	-0.10	-0.20	-0.21	-0.20	-0.19	-0.14	
	Balance	0.10	0.18	0.20	0.19	0.18	0.13	
<b>3. Changes to Retirement Age or Actuarial Adjustments</b>								
3.1 Eliminate NRA hiatus to 67 phased in 2006-2011	Revenues	-0.01	0.00	0.00	0.00	0.00	0.00	2047
	Outlays	-0.18	-0.03	0.00	0.00	0.00	-0.05	
	Balance	0.17	0.03	0.00	0.00	0.00	0.05	
3.2 Eliminate NRA hiatus to 67 and continue rise to 69 phased in 2006-2017	Revenues	-0.02	-0.02	-0.02	-0.02	-0.02	-0.04	2052
	Outlays	-0.30	-0.29	-0.28	-0.28	-0.28	-0.23	
	Balance	0.28	0.29	0.26	0.27	0.24	0.22	
3.3 Eliminate NRA hiatus to 67 and continue rise to 70 phased in 2006-2029	Revenues	-0.02	-0.04	-0.05	-0.05	-0.06	-0.03	2063
	Outlays	-0.31	-0.67	-0.78	-0.78	-0.77	-0.48	
	Balance	0.29	0.62	0.72	0.72	0.71	0.44	
3.4 Raise FEA to 65 phased in 2003-2040	Revenues	0.00	0.00	0.01	0.02	0.02	0.00	2046
	Outlays	0.00	-0.07	0.19	0.31	0.31	0.02	
	Balance	0.00	0.07	-0.18	-0.26	-0.26	-0.02	

Changes to Social Security Financial Outcomes Under Various Provisions  
Projections Under Scheduled Baseline

	Change in Revenues, Outlays and Balance (Revenues Less Outlays) as a % of GDP					Change in 75 Year PV Deficit as a % of Payroll	Revenues Fall Below Outlays	Trust Fund Exhaustion Year
	Year							
	2020	2040	2060	2100	2160			
3.5 Raise actuarial reduction factor to maximum of 1.15 phased in 2003-2012	Revenues	-0.01	-0.01	-0.01	-0.02	-0.01	-0.02	2048
	Outlays	-0.11	-0.20	-0.20	-0.19	-0.14	-0.37	
	Balance	0.10	0.19	0.19	0.16	0.13	0.35	
3.6 Raise delayed retirement credit to 10% per year phased in 2003-2015	Revenues	0.00	0.00	0.01	0.01	0.00	0.00	2044
	Outlays	0.01	0.02	0.02	0.03	0.01	0.03	
	Balance	-0.01	-0.02	-0.01	-0.02	-0.01	-0.03	
<b>4. Changes to COLA</b>								
4.1 Reduce benefit COLAs by 0.2 percentage points beginning in 2012	Revenues	0.00	-0.01	-0.01	0.00	0.00	-0.02	2047
	Outlays	-0.07	-0.17	-0.17	-0.18	-0.11	-0.30	
	Balance	0.07	0.16	0.16	0.17	0.18	0.29	
4.2 Reduce benefit COLAs by 0.4 percentage points beginning in 2012	Revenues	-0.01	-0.02	-0.02	-0.01	-0.02	-0.01	2051
	Outlays	-0.14	-0.33	-0.35	-0.37	-0.22	-0.60	
	Balance	0.14	0.31	0.33	0.35	0.21	0.57	
4.3 Introduce super-COLA for DI workers of 1.5 percentage points beginning in 2012	Revenues	0.00	0.01	0.01	0.01	0.02	0.01	2042
	Outlays	0.06	0.19	0.23	0.22	0.25	0.35	
	Balance	-0.06	-0.18	-0.21	-0.21	-0.23	-0.35	
<b>5. Changes to Payroll Tax Rates or Taxable Maximum</b>								
5.1 Increase payroll tax rate by 1% in 2007, 0.5% employers beginning in 2007	Revenues	0.37	0.35	0.34	0.33	0.31	0.28	2051
	Outlays	N/A	N/A	N/A	N/A	N/A	N/A	
	Balance	0.37	0.37	0.37	0.35	0.33	0.28	
5.2 Raise taxable maximum to cover 87% of earnings phased in 2007-2050	Revenues	0.08	0.18	0.20	0.21	0.22	0.13	2047
	Outlays	0.00	0.03	0.07	0.10	0.13	0.03	
	Balance	0.08	0.15	0.13	0.11	0.10	0.30	
5.3 Raise taxable maximum cover 80% of earnings phased in 2007-2100	Revenues	0.08	0.18	0.26	0.32	0.36	0.15	2047
	Outlays	0.00	0.03	0.07	0.12	0.18	0.03	
	Balance	0.08	0.15	0.18	0.20	0.18	0.35	
5.4 Raise taxable maximum to \$250,000 with no additional benefits beginning in 2007	Revenues	0.68	0.67	0.67	0.64	0.63	-0.19	2053
	Outlays	N/A	N/A	N/A	N/A	N/A	-1.95	
	Balance	0.68	0.71	0.71	0.68	0.67	1.77	
5.5 Apply 3% tax to all earnings except the taxable maximum beginning in 2007	Revenues	0.22	0.21	0.21	0.21	0.20	1.76	2053
	Outlays	N/A	N/A	N/A	N/A	N/A	-2.53	
	Balance	0.22	0.23	0.21	0.22	0.20	0.78	

**Changes to Social Security Financial Outcomes Under Various Provisions  
Projections Under Scheduled Baseline**

	Change in Revenues, Outlays and Balance (Revenues Less Outlays) as a % of GDP					Change in 75 Year PV Deficit as a % of Taxable Payroll	Revenues Fall Below Outlays	Trust Fund Exhaustion Year
	Year							
	2020	2040	2060	2080	2100			
<b>6. Changes to Benefits for Low Earners</b>								
6.1 Introduce poverty-related minimum benefit beginning in 2007	Revenues	0.00	0.00	0.01	0.01	0.00	0.01	2043
	Outlays Balance	0.04 -0.04	0.09 -0.08	0.12 -0.11	0.11 -0.11	0.12 -0.11	0.18 -0.17	
6.2 Enhance low-earner benefits based on years worked beginning in 2007	Revenues	0.01	0.02	0.02	0.02	0.01	0.03	2041
	Outlays Balance	0.13 -0.12	0.33 -0.31	0.36 -0.34	0.35 -0.34	0.35 -0.33	0.61 -0.58	
<b>7. Changes to Auxiliary Benefits</b>								
7.1 Limit spouse's benefit for high-earner couples beginning in 2007	Revenues	0.00	0.00	0.00	0.00	0.00	0.00	2045
	Outlays Balance	-0.01 0.01	-0.02 0.02	-0.02 0.02	-0.03 0.02	-0.03 0.02	-0.04 0.01	
7.2 Reduce spouse's benefit to 33% of workers benefit beginning in 2007	Revenues	0.00	0.02	0.00	-0.01	0.00	-0.01	2046
	Outlays Balance	-0.08 0.08	-0.02 0.05	-0.07 0.07	-0.08 0.07	-0.08 0.07	-0.15 0.14	
7.3 Raise low-earner widow(er) benefits to 75% of couple's benefit beginning in 2007	Revenues	0.00	0.00	0.00	0.00	0.00	0.00	2044
	Outlays Balance	0.01 -0.01	0.03 -0.02	0.02 -0.02	0.02 -0.02	0.02 -0.02	0.05 -0.04	

Source: Congressional Budget Office  
 Notes: Based on a simulation using the Social Security trustees' 2005 intermediate demographic and long-run economic assumptions and CBO's January 2005 short-run economic assumptions.  
 Revenues equal payroll taxes and income taxes on benefits as a share of gross domestic product (GDP) in the specified year.  
 Outlays equal scheduled Social Security benefits and administrative costs as a share of GDP in the specified year.  
 The balance is the difference between revenues and outlays as a share of GDP in the specified year and may not equal the difference of the previous two rows because of rounding.  
 N/A reflects results under provisions that would have no direct effects on revenues or outlays.  
 A trust fund exhaustion year value of "None" reflects a provision that makes the trust fund solvent throughout the 100-year projection period.  
 \* Revenues exceed outlays in some later year.

**Table 2. Summary Measures of Social Security Distributional Outcomes by Ten Year Birth Cohort and Lifetime Earnings Quintile Projections Under Scheduled Baseline**

Lifetime Earnings Quintile	First-Year Benefits Retired Workers at Age 65 (2005 Dollars)				Present Value at Age 60 Lifetime Benefits (2005 Dollars)				Present Value at Age 60 Lifetime Payroll Taxes (2005 Dollars)			
	1980s		2000s		1980s		2000s		1980s		2000s	
	Birth Cohort	1980s	2000s	Birth Cohort	1980s	2000s	Birth Cohort	1980s	2000s	Birth Cohort	1980s	2000s
Lowest	49,200	\$10,300	\$12,800	\$102,000	\$117,000	\$152,000	\$69,000	\$72,000	\$87,000	1980s	2000s	
Middle	48,700	20,800	26,100	191,000	250,000	322,000	250,000	314,000	381,000	1980s	2000s	
Highest	23,900	29,800	36,700	285,000	355,000	465,000	460,000	636,000	793,000	1980s	2000s	

**Changes to Social Security Distributional Outcomes Under Various Provisions by Ten Year Birth Cohort and Lifetime Earnings Quintile Projections Under Scheduled Baseline**

Lifetime Earnings Quintile	Percentage Change in First-Year Benefits for Retired Workers at Age 65				Percentage Change in Lifetime Benefits				Percentage Change in Lifetime Payroll Taxes			
	1980s		2000s		1980s		2000s		1980s		2000s	
	Birth Cohort	1980s	2000s	Birth Cohort	1980s	2000s	Birth Cohort	1980s	2000s	Birth Cohort	1980s	2000s
Lowest	-16.0	-31.6	-44.8	-8.4	-22.0	-37.4	N/A	N/A	N/A	N/A	N/A	N/A
Middle	-15.9	-31.9	-44.9	-13.3	-28.8	-42.1	N/A	N/A	N/A	N/A	N/A	N/A
Highest	-15.7	-31.4	-44.0	-14.2	-29.4	-42.3	N/A	N/A	N/A	N/A	N/A	N/A
Lowest	0.0	0.0	0.0	-1.8	-3.0	-7.6	N/A	N/A	N/A	N/A	N/A	N/A
Middle	-8.9	-16.6	-27.8	-7.2	-17.3	-24.9	N/A	N/A	N/A	N/A	N/A	N/A
Highest	-15.0	-30.4	-42.6	-13.4	-28.1	-40.3	N/A	N/A	N/A	N/A	N/A	N/A
Lowest	-9.6	-23.7	-33.2	-4.3	-13.3	-22.6	N/A	N/A	N/A	N/A	N/A	N/A
Middle	-8.6	-16.7	-27.0	-5.9	-17.6	-25.4	N/A	N/A	N/A	N/A	N/A	N/A
Highest	-9.8	-22.6	-30.0	-8.0	-19.8	-26.8	N/A	N/A	N/A	N/A	N/A	N/A
Lowest	-1.1	-6.0	-9.7	-0.7	-4.3	-7.3	N/A	N/A	N/A	N/A	N/A	N/A
Middle	-2.1	-8.2	-11.5	-1.3	-6.9	-8.1	N/A	N/A	N/A	N/A	N/A	N/A
Highest	-7.3	-17.3	-25.5	-4.9	-12.2	-16.9	N/A	N/A	N/A	N/A	N/A	N/A
Lowest	-8.6	-17.9	-26.3	-3.5	-9.3	-17.8	N/A	N/A	N/A	N/A	N/A	N/A
Middle	-8.6	-11.7	-21.3	-4.9	-11.8	-16.9	N/A	N/A	N/A	N/A	N/A	N/A
Highest	-8.4	-16.8	-23.5	-6.8	-14.8	-21.3	N/A	N/A	N/A	N/A	N/A	N/A

**1. Changes to Indexing of Benefits**

- 1.1 Grow initial benefits with prices rather than wages beginning in 2012
- 1.2 Grow initial benefits slower than wages for top 70% beginning in 2012 ("progressive price indexing")
- 1.3 Price index earnings in AIME formula and bend points in PIA formula beginning in 2012
- 1.4 Price index earnings in AIME formula beginning in 2012
- 1.5 Price index bend points in PIA formula beginning in 2012

**Changes to Social Security Distributional Outcomes Under Various Provisions  
by Ten Year Birth Cohort and Lifetime Earnings Quintile  
Projections Under Scheduled Baseline**

	Lifetime Earnings Quintile	Percentage Change in First-Year Benefits for Retired Workers at Age 65				Percentage Change in Lifetime Benefits				Percentage Change in Lifetime Payroll Taxes			
		1980s		2000s		1980s		2000s		1980s		2000s	
		Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest
<b>1.6 Longevity index initial benefits beginning in 2012</b>													
	Lowest	-4.4	-3.0	-13.3	-1.6	-3.4	-5.4	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	-4.1	-6.6	-13.7	-2.6	-6.1	N/A	N/A	N/A	N/A	N/A	N/A	N/A
	Highest	-4.3	-9.3	-13.6	-3.2	-7.0	-10.3	N/A	N/A	N/A	N/A	N/A	N/A
<b>2. Changes to Benefit Formula</b>													
<b>2.1 Reduce all PIA factors by 20% in 2012</b>													
	Lowest	-18.7	-19.3	-19.8	-12.2	-18.3	-20.1	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	-19.9	-19.8	-20.0	-17.6	-19.4	-19.2	N/A	N/A	N/A	N/A	N/A	N/A
	Highest	-19.5	-19.3	-19.1	-18.0	-18.2	-18.2	N/A	N/A	N/A	N/A	N/A	N/A
<b>2.2 Reduce top two PIA factors from 32% to 20% and from 15% to 10% in 2012</b>													
	Lowest	-4.6	-3.1	-3.3	-5.9	-8.7	-11.7	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	-19.5	-20.1	-20.4	-17.2	-19.6	-19.9	N/A	N/A	N/A	N/A	N/A	N/A
	Highest	-24.6	-24.6	-24.5	-22.5	-23.0	-23.1	N/A	N/A	N/A	N/A	N/A	N/A
<b>2.3 Reduce top PIA factor from 15% to 10% in 2012</b>													
	Lowest	0.0	0.0	0.0	0.0	0.0	-2.4	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	0.0	0.0	0.0	0.0	-0.5	0.0	N/A	N/A	N/A	N/A	N/A	N/A
	Highest	-3.8	-4.3	-4.6	-3.9	-4.5	-4.4	N/A	N/A	N/A	N/A	N/A	N/A
<b>2.4 Reduce all PIA factors by 0.065 annually beginning in 2011</b>													
	Lowest	-7.7	-15.1	-24.1	-4.1	-11.0	-18.7	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	-7.7	-18.0	-24.6	-8.4	-14.3	-21.2	N/A	N/A	N/A	N/A	N/A	N/A
	Highest	-7.9	-19.1	-23.7	-9.0	-14.9	-22.4	N/A	N/A	N/A	N/A	N/A	N/A
<b>2.5 Increase AME calculation years from 35 to 40 phased in 2007-2011</b>													
	Lowest	-5.1	-3.8	-4.8	-2.5	-2.1	-3.1	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	-8.9	-7.5	-7.7	-3.8	-3.7	-4.7	N/A	N/A	N/A	N/A	N/A	N/A
	Highest	-4.3	-4.5	-4.2	-2.8	-2.1	-2.0	N/A	N/A	N/A	N/A	N/A	N/A
<b>3. Changes to Retirement Age or Actuarial Adjustments</b>													
<b>3.1 Eliminate NRA hiatus to 67 phased in 2006-2010</b>													
	Lowest	0.0	0.0	0.0	0.0	0.0	0.0	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	0.0	0.0	0.0	0.0	0.0	0.0	N/A	N/A	N/A	N/A	N/A	N/A
	Highest	0.0	0.0	0.0	0.0	0.0	0.0	N/A	N/A	N/A	N/A	N/A	N/A
<b>3.2 Eliminate NRA hiatus to 67 and continue rise to 68 phased in 2008-2017</b>													
	Lowest	-7.5	-7.5	-7.5	-2.4	-2.1	-3.8	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	-7.7	-7.5	-7.4	-4.2	-4.3	-3.5	N/A	N/A	N/A	N/A	N/A	N/A
	Highest	-7.4	-7.3	-7.1	-4.9	-4.4	-4.7	N/A	N/A	N/A	N/A	N/A	N/A
<b>3.3 Eliminate NRA hiatus to 67 and continue rise to 70 phased in 2009-2029</b>													
	Lowest	-16.4	-18.5	-18.1	-6.0	-6.9	-7.2	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	-16.0	-18.9	-18.9	-10.1	-11.6	-10.8	N/A	N/A	N/A	N/A	N/A	N/A
	Highest	-15.8	-19.4	-19.2	-11.8	-13.9	-13.2	N/A	N/A	N/A	N/A	N/A	N/A
<b>3.4 Raise EEA to 65 phased in 2023-2040</b>													
	Lowest	0.0	3.6	2.9	0.0	2.5	4.2	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	0.0	4.7	4.1	0.0	4.1	4.1	N/A	N/A	N/A	N/A	N/A	N/A
	Highest	0.0	4.1	3.9	0.8	5.8	5.3	N/A	N/A	N/A	N/A	N/A	N/A

Changes to Social Security Distributional Outcomes Under Various Provisions  
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Projections Under Scheduled Baseline

Lifetime Earnings Quintile	Percentage Change in First-Year Benefits for Retired Workers at Age 65				Percentage Change in Lifetime Benefits				Percentage Change in Lifetime Payroll Taxes			
	1980s		2000s		1980s		2000s		1980s		2000s	
	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest
3.5 Raise actuarial reduction factor to maximum 37% phased in 2009-2012	-3.7	-3.5	-3.8	-2.2	-1.7	-2.8	N/A	N/A	N/A	N/A	N/A	N/A
3.6 Raise delayed retirement credit to 10% per year phased in 2009-2015	N/A	N/A	N/A	N/A	0.2	1.0	0.8	N/A	N/A	N/A	N/A	N/A
4.1 Reduce benefit COLAs by 0.2 percentage points beginning in 2012	-0.6	-0.2	0.1	-1.8	-1.7	-2.2	N/A	N/A	N/A	N/A	N/A	N/A
4.2 Reduce benefit COLAs by 0.4 percentage points beginning in 2012	-1.0	-1.1	-1.3	-3.3	-3.7	-3.8	N/A	N/A	N/A	N/A	N/A	N/A
4.3 Introduce super-COLA for DI workers of 1.2 percentage points beginning in 2012	N/A	N/A	N/A	N/A	4.0	0.5	9.3	N/A	N/A	N/A	N/A	N/A
5.1 Increase payroll tax rates by 1% for 0.5% individuals, 0.5% employers beginning in 2007	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	3.1	6.8
5.2 Raise taxable maximum to cover 97% of earnings phased in 2007-2050	0.0	0.0	0.0	0.0	0.0	1.5	-0.5	0.0	0.0	0.0	0.0	-0.8
5.3 Raise taxable maximum to cover 90% of earnings phased in 2007-2100	0.0	0.0	0.0	0.0	0.0	1.4	0.0	0.3	0.0	0.0	0.0	0.0
5.4 Raise taxable maximum to \$50,000 with no additional benefits beginning in 2007	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
5.5 Apply 3% tax to all earnings above the taxable maximum beginning in 2007	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

4. Changes to COLA

5. Changes to Payroll Tax Rates or Taxable Maximum

**Changes to Social Security Distributional Outcomes Under Various Provisions by Ten Year Birth Cohort and Lifetime Earnings Quintile Projections Under Scheduled Baseline**

Lifetime Earnings Quintile	Percentage Change in First-Year Benefits for Retired Workers at Age 65			Percentage Change in Lifetime Benefits			Percentage Change in Lifetime Payroll Taxes		
	Birth Cohort			Birth Cohort			Birth Cohort		
	1960s	1980s	2000s	1960s	1980s	2000s	1960s	1980s	2000s
<b>6. Changes to Benefits for Low Earners</b>									
<b>6.1 Introduce poverty-related minimum benefit beginning in 2007</b>									
Lowest	5.1	14.3	12.7	4.3	15.0	15.4	N/A	N/A	N/A
Middle	0.0	0.0	0.0	0.0	0.0	0.8	N/A	N/A	N/A
Highest	0.0	0.0	0.0	0.0	0.0	0.0	N/A	N/A	N/A
<b>6.2 Enhance low-earner benefits based on years worked beginning in 2007</b>									
Lowest	23.0	21.4	21.6	10.7	21.8	22.5	N/A	N/A	N/A
Middle	2.7	2.0	1.1	4.2	4.7	4.9	N/A	N/A	N/A
Highest	0.0	0.0	0.0	0.0	0.7	0.0	N/A	N/A	N/A
<b>7. Changes to Auxiliary Benefits</b>									
<b>7.1 Limit spouse's benefit for high-earner couples beginning in 2007</b>									
Lowest	N/A	N/A	N/A	-0.7	-1.0	-1.1	N/A	N/A	N/A
Middle	N/A	N/A	N/A	-0.1	-0.1	0.0	N/A	N/A	N/A
Highest	N/A	N/A	N/A	-0.3	-0.5	-0.6	N/A	N/A	N/A
<b>7.2 Reduce spouse's benefit to 33% of workers benefit beginning in 2007</b>									
Lowest	N/A	N/A	N/A	-2.8	-6.0	-3.5	N/A	N/A	N/A
Middle	N/A	N/A	N/A	-0.4	-0.9	-0.3	N/A	N/A	N/A
Highest	N/A	N/A	N/A	-0.5	0.1	-0.3	N/A	N/A	N/A
<b>7.3 Raise low-earner widow(er) benefits to 75% of couple's benefit beginning in 2007</b>									
Lowest	N/A	N/A	N/A	1.0	1.1	1.0	N/A	N/A	N/A
Middle	N/A	N/A	N/A	0.4	0.4	0.0	N/A	N/A	N/A
Highest	N/A	N/A	N/A	0.0	0.4	0.0	N/A	N/A	N/A

Source: Congressional Budget Office  
 Notes: Based on a simulation using the Social Security Trustees' 2005 intermediate demographic and long-run economic assumptions and CBO's January 2005 short-run economic assumptions.  
 First-year annual benefits are computed for all workers eligible to claim Old-Age insurance benefits at age 62 who have not yet claimed any other benefit. Benefits are computed assuming claim at age 65, based only on earnings through age 61. All values are net of income taxes paid on benefits and credited to the Social Security trust funds. Lifetime benefits include Old-Age and Disability worker benefits and Old-Age Spouse and Survivor benefits received by each individual during his or her lifetime net of income taxes credited to the Social Security trust funds. Lifetime taxes include OASDI employer and employee taxes.  
 N/A reflects results under provisions that would have no direct effects on benefits or taxes.

**Table 3. Summary Measures of Social Security Distributional Outcomes by Ten Year Birth Cohort and Lifetime Earnings Quintile Projections Under Current Law Baseline**

Lifetime Earnings Quintile	First-Year Benefits for Retired Workers at Age 65 (2005 Dollars)			Present Value at Age 60 Lifetime Benefits (2005 Dollars)			Present Value at Age 60 Lifetime Payroll Taxes (2005 Dollars)		
	Birth Cohort			Birth Cohort			Birth Cohort		
	1960s	1980s	2000s	1960s	1980s	2000s	1960s	1980s	2000s
Lowest	\$8,200	\$7,500	\$8,100	\$101,000	\$113,000	\$113,000	\$65,000	\$72,000	\$87,000
Middle	16,700	16,000	18,500	182,000	193,000	224,000	252,000	308,000	384,000
Highest	23,900	22,900	28,000	266,000	275,000	323,000	483,000	633,000	794,000

**Changes to Social Security Distributional Outcomes Under Various Provisions by Ten Year Birth Cohort and Lifetime Earnings Quintile Projections Under Current Law Baseline**

Lifetime Earnings Quintile	Percentage Change in First-Year Benefits for Retired Workers at Age 65			Percentage Change in Lifetime Benefits			Percentage Change in Lifetime Payroll Taxes		
	Birth Cohort			Birth Cohort			Birth Cohort		
	1960s	1980s	2000s	1960s	1980s	2000s	1960s	1980s	2000s
Lowest	-18.0	-9.9	-21.8	-6.0	-8.4	-13.5	N/A	N/A	N/A
Middle	-15.9	-10.1	-8.2	-7.5	-7.5	-16.8	N/A	N/A	N/A
Highest	-15.7	-9.9	-21.0	-6.5	-5.7	-16.8	N/A	N/A	N/A
Lowest	0.0	32.1	32.3	0.7	15.4	23.4	N/A	N/A	N/A
Middle	-8.9	7.5	-5.0	-1.7	5.7	3.1	N/A	N/A	N/A
Highest	-15.0	-8.5	-24.5	-5.7	-8.2	-17.3	N/A	N/A	N/A
Lowest	-9.6	0.5	-5.2	-1.9	4.0	7.0	N/A	N/A	N/A
Middle	-6.8	7.4	3.2	-0.3	7.0	7.3	N/A	N/A	N/A
Highest	-9.8	1.9	-1.2	0.2	7.1	5.7	N/A	N/A	N/A
Lowest	-1.1	-3.2	-3.0	0.0	-0.7	-0.9	N/A	N/A	N/A
Middle	-2.0	-3.5	-3.2	0.2	-0.0	0.0	N/A	N/A	N/A
Highest	-1.4	-2.2	0.9	1.0	0.9	0.0	N/A	N/A	N/A
Lowest	-8.4	2.6	-10.1	-1.4	2.5	0.0	N/A	N/A	N/A
Middle	-4.6	9.5	-4.1	-0.3	3.2	0.0	N/A	N/A	N/A
Highest	-8.4	3.4	-7.1	-0.4	0.0	-0.9	N/A	N/A	N/A

**1. Changes to Benefit Growth Rates**

1.1	Grow initial benefits with prices rather than wages beginning in 2012	Lowest: -18.0, Middle: -15.9, Highest: -15.7	Lowest: -9.9, Middle: -10.1, Highest: -9.9	Lowest: -21.8, Middle: -8.2, Highest: -21.0	Lowest: -6.0, Middle: -7.5, Highest: -6.5	Lowest: -8.4, Middle: -7.5, Highest: -5.7	Lowest: -13.5, Middle: -16.8, Highest: -16.8	N/A	N/A	N/A
1.2	Grow initial benefits slower than wages for top 70% beginning in 2012 ("progressive price indexing")	Lowest: 0.0, Middle: -8.9, Highest: -15.0	Lowest: 32.1, Middle: 7.5, Highest: -8.5	Lowest: 32.3, Middle: -5.0, Highest: -24.5	Lowest: 0.7, Middle: -1.7, Highest: -5.7	Lowest: 15.4, Middle: 5.7, Highest: -8.2	Lowest: 23.4, Middle: 3.1, Highest: -17.3	N/A	N/A	N/A
1.3	Price index earnings in AIME formula and bend points in PIA formula beginning in 2012	Lowest: -9.6, Middle: -6.8, Highest: -9.8	Lowest: 0.5, Middle: 7.4, Highest: 1.9	Lowest: -5.2, Middle: 3.2, Highest: -1.2	Lowest: -1.9, Middle: -0.3, Highest: 0.2	Lowest: 4.0, Middle: 7.0, Highest: 7.1	Lowest: 7.0, Middle: 7.3, Highest: 5.7	N/A	N/A	N/A
1.4	Price index earnings in AIME formula beginning in 2012	Lowest: -1.1, Middle: -2.0, Highest: -1.4	Lowest: -3.2, Middle: -3.5, Highest: -2.2	Lowest: -3.0, Middle: -3.2, Highest: 0.9	Lowest: 0.0, Middle: 0.2, Highest: 0.9	Lowest: -0.7, Middle: -0.0, Highest: 0.0	Lowest: -0.9, Middle: 0.0, Highest: 0.0	N/A	N/A	N/A
1.5	Price index bend points in PIA formula beginning in 2012	Lowest: -8.4, Middle: -4.6, Highest: -8.4	Lowest: 2.6, Middle: 9.5, Highest: 3.4	Lowest: -10.1, Middle: -4.1, Highest: -7.1	Lowest: -1.4, Middle: -0.3, Highest: -0.4	Lowest: 2.5, Middle: 3.2, Highest: 0.0	Lowest: 0.0, Middle: -0.3, Highest: -0.9	N/A	N/A	N/A

Changes to Social Security Distributional Outcomes Under Various Provisions  
by Ten Year Birth Cohort and Lifetime Earnings Quintile  
Projections Under Current Law Baseline

Lifetime Earnings Quintile	Percentage Change in First-Year Benefits for Retired Workers at Age 65				Percentage Change in Lifetime Benefits				Percentage Change in Lifetime Payroll Taxes			
	1960s Birth Cohort		2000s Birth Cohort		1960s Birth Cohort		2000s Birth Cohort		1960s Birth Cohort		2000s Birth Cohort	
	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest
1.6 Longevity index initial benefits beginning in 2012	-4.4	-4.1	-3.9	-6.3	-0.5	1.3	3.4	N/A	N/A	N/A	N/A	N/A
	-4.1	-4.1	-3.9	-6.7	-0.5	0.2	0.2	N/A	N/A	N/A	N/A	N/A
	-4.3	-4.1	-4.1	-6.6	-0.4	-1.5	-2.2	N/A	N/A	N/A	N/A	N/A
<b>2. Changes to Benefit Formula</b>												
2.1 Reduce all PIA factors by 20% in 2012	-19.7	-19.9	6.0	13.6	-10.0	-1.9	10.5	N/A	N/A	N/A	N/A	N/A
	-19.9	-19.9	6.0	13.1	-12.7	4.7	18.2	N/A	N/A	N/A	N/A	N/A
	-19.5	-19.5	5.9	14.2	-10.5	9.2	15.1	N/A	N/A	N/A	N/A	N/A
2.2 Reduce top PIA factors from 32% to 20% and from 15% to 10% in 2012	-4.6	-19.5	5.6	12.8	-12.2	4.5	16.6	N/A	N/A	N/A	N/A	N/A
	-24.6	-19.5	5.6	6.8	-15.5	2.9	11.0	N/A	N/A	N/A	N/A	N/A
2.3 Reduce top PIA factor from 15% to 10% in 2012	0.0	2.4	2.2	2.2	0.0	2.0	1.0	N/A	N/A	N/A	N/A	N/A
	0.0	2.3	1.5	1.0	1.0	1.2	2.6	N/A	N/A	N/A	N/A	N/A
	-3.8	-2.6	-2.6	-2.3	-2.3	-2.8	-2.4	N/A	N/A	N/A	N/A	N/A
2.4 Reduce all PIA factor by 0.005 annually beginning in 2011	-7.7	-7.7	7.8	-8.0	-1.9	1.2	0.0	N/A	N/A	N/A	N/A	N/A
	-7.7	-7.7	7.8	-8.7	-1.5	1.2	0.0	N/A	N/A	N/A	N/A	N/A
	-7.5	-7.5	7.8	-5.9	0.0	2.4	0.9	N/A	N/A	N/A	N/A	N/A
2.5 Increase AIME calculation years from 35 to 40 phased in 2007-2011	-5.1	-7.0	-0.2	-4.8	-1.3	1.6	2.3	N/A	N/A	N/A	N/A	N/A
	-7.0	-7.0	-0.2	-4.8	-1.5	0.0	-0.9	N/A	N/A	N/A	N/A	N/A
	-4.3	-4.3	1.7	0.0	0.0	1.0	1.3	N/A	N/A	N/A	N/A	N/A
<b>3. Changes to Retirement Age or Actuarial Adjustments</b>												
3.1 Eliminate NRA hiatus to 67 phased in 2006-2011	0.0	0.0	2.9	0.5	0.9	1.2	2.0	N/A	N/A	N/A	N/A	N/A
	0.0	3.8	-0.2	1.5	0.9	0.9	0.8	N/A	N/A	N/A	N/A	N/A
	0.0	2.9	0.5	2.0	0.5	0.5	0.5	N/A	N/A	N/A	N/A	N/A
3.2 Eliminate NRA hiatus to 67 and continue rise to 68 phased in 2006-2017	-7.5	-7.5	12.0	-2.2	-0.4	5.2	5.2	N/A	N/A	N/A	N/A	N/A
	-7.6	-7.6	12.8	-2.5	-0.1	4.5	1.7	N/A	N/A	N/A	N/A	N/A
	-7.4	-7.4	12.4	-2.0	0.6	2.3	-0.2	N/A	N/A	N/A	N/A	N/A
3.3 Eliminate NRA hiatus to 67 and continue rise to 70 phased in 2005-2029	-16.3	-16.0	7.2	-7.9	-8.6	8.5	10.9	N/A	N/A	N/A	N/A	N/A
	-15.8	-15.8	7.2	-7.9	-8.6	8.6	3.7	N/A	N/A	N/A	N/A	N/A
	-15.8	-15.8	7.2	-6.7	-4.1	5.5	-1.0	N/A	N/A	N/A	N/A	N/A
3.4 Raise EEA to 65 phased in 2023-2040	0.0	0.0	3.4	-0.3	0.5	1.7	0.7	N/A	N/A	N/A	N/A	N/A
	0.0	0.0	3.4	0.0	2.1	2.1	0.0	N/A	N/A	N/A	N/A	N/A
	0.0	0.0	3.9	0.8	1.8	2.6	0.4	N/A	N/A	N/A	N/A	N/A



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	Lifetime Earnings Quintile	Percentage Change in First-Year Benefits for Retired Workers at Age 65				Percentage Change in Lifetime Benefits				Percentage Change in Lifetime Payroll Taxes			
		1960s Birth Cohort		2000s Birth Cohort		1960s Birth Cohort		2000s Birth Cohort		1960s Birth Cohort		2000s Birth Cohort	
		1960s	1980s	2000s	2000s	1960s	1980s	2000s	2000s	1960s	1980s	2000s	2000s
<b>6. Changes to Benefits for Low Earners</b>													
6.1 Introduce poverty-related minimum benefit beginning in 2007	Lowest	5.1	12.7	10.0	3.4	3.4	13.0	13.7	N/A	N/A	N/A	N/A	N/A
	Middle	0.0	-1.3	-2.3	-0.8	-1.7	-1.4	-1.4	N/A	N/A	N/A	N/A	N/A
	Highest	0.0	-1.5	-1.8	-1.5	-1.7	-1.8	-1.8	N/A	N/A	N/A	N/A	N/A
6.2 Enhance low-earner benefits based on years worked beginning in 2007	Lowest	23.0	16.5	15.3	7.7	7.7	15.5	16.6	N/A	N/A	N/A	N/A	N/A
	Middle	2.7	-1.9	-5.3	0.0	-1.7	-1.5	-1.5	N/A	N/A	N/A	N/A	N/A
	Highest	0.0	-4.3	-5.7	-4.9	-4.4	-4.7	-4.7	N/A	N/A	N/A	N/A	N/A
<b>7. Changes to Auxiliary Benefits</b>													
7.1 Limit spouse's benefit for high-earner couples beginning in 2007	Lowest	N/A	0.0	0.7	-0.5	-1.1	-1.2	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	N/A	-0.2	0.0	0.0	0.0	0.0	0.7	N/A	N/A	N/A	N/A	N/A
	Highest	N/A	0.0	0.5	0.0	0.0	0.0	0.0	N/A	N/A	N/A	N/A	N/A
7.2 Reduce spouse benefit to 33% of worker PIA beginning in 2007	Lowest	N/A	1.8	1.2	-2.3	-3.9	-1.1	N/A	N/A	N/A	N/A	N/A	N/A
	Middle	N/A	1.8	1.4	0.7	0.8	0.9	0.9	N/A	N/A	N/A	N/A	N/A
	Highest	N/A	1.7	1.5	1.0	0.9	0.9	0.9	N/A	N/A	N/A	N/A	N/A
7.3 Raise low-earner widow(er) benefits to 75% of couple's benefit beginning in 2007	Lowest	N/A	0.0	0.0	0.8	0.0	0.0	0.0	N/A	N/A	N/A	N/A	N/A
	Middle	N/A	-0.5	-0.8	0.0	0.0	0.0	0.0	N/A	N/A	N/A	N/A	N/A
	Highest	N/A	-0.6	-0.5	0.0	0.0	0.0	0.0	N/A	N/A	N/A	N/A	N/A

Source: Congressional Budget Office  
 Notes: Based on a simulation using the Social Security trustees' 2005 intermediate demographic and long-run economic assumptions and CBO's January 2005 short-run economic assumptions.  
 First-year annual benefits are computed for all workers eligible to claim Old-Age Insurance benefits at age 62 who have not yet claimed any other benefit. Benefits are computed assuming claim at age 65, based only on earnings through age 61. All values are net of income taxes paid on benefits and credited to the Social Security trust funds. Lifetime benefits include Old-Age and Disability worker benefits and Old-Age Spouse and Survivor benefits received by each individual during his or her lifetime net of income taxes credited to the Social Security trust funds. Lifetime taxes include OASDI employer and employee payroll taxes.  
 Under current law, all beneficiaries are subject to an across-the-board cut in benefits such that total projected outlays equal projected revenues one the Social Security trust funds have been exhausted. Under each provision, similar cuts are applied at the relevant trust fund exhaustion date (see Table 1).  
 N/A reflects results under provisions that would have no direct effects on benefits or taxes.

### Appendix: Description of Social Security Provisions

Under current law, initial Social Security benefits are wage indexed. All Social Security benefits are based on a worker's primary insurance amount (PIA). In turn, the PIA depends on a measure of the worker's career earnings in employment subject to the Social Security payroll tax, expressed as his or her average indexed monthly earnings (AIME).

*AIME.* For people who attain age 62 after 1990, the AIME is calculated based on the highest 35 years of earnings on which the individual paid Social Security taxes (up to the taxable maximum, which is \$90,000 in 2005). Earnings before age 60 are indexed to compensate for past growth in average (nominal) wages, and earnings after age 59 enter the computation at their actual levels. Dividing the total earnings by 420 (35 years times 12 months) yields the AIME.

*PIA.* The PIA is the monthly amount payable to a worker who begins receiving Social Security retirement benefits at the age at which he or she is eligible for full benefits or payable to a disabled worker who has never received a retirement benefit. The PIA formula is designed to ensure that initial Social Security benefits replace a larger proportion of preretirement earnings for people with low average earnings than for those with higher earnings. For workers who turn 62, become disabled, or die in 2005, the formula is:

$$\begin{aligned} \text{PIA} = & \text{(90 percent of the first \$627 of the AIME) +} \\ & \text{(32 percent of the AIME between \$627 and \$3,779) +} \\ & \text{(15 percent of the AIME over \$3,779)} \end{aligned}$$

The percentages of the AIME are known as "PIA factors" or "replacement factors" and remain unchanged. The thresholds at which the percentage of the AIME changes are known as "bend points." They change each year along with changes in the average annual earnings for the labor force as a whole. Consequently, as wages rise over time, initial benefits increase at a similar pace or are said to be "wage-indexed."

In addition, at the end of each year after participants become eligible for benefits, the Social Security Administration (SSA) adjusts the PIA by the amount of any increase in the consumer price index (CPI). Those annual cost-of-living adjustments are designed to ensure that the purchasing power of benefits does not decline.

## 1. Changes to Benefit Growth Rates

1. Under this provision, initial benefits for retired and disabled workers grow with the CPI beginning in 2012. In practice, the policy would be implemented by reducing the PIA replacement factors successively by the measured real wage growth in the second prior year. The bend points would remain indexed to wages. (This is the provision proposed by the Commission to Strengthen Social Security.)
2. This provision, often described as “progressive indexing,” does not change the benefits for those in the bottom 30 percent of career average earnings. Initial benefits for higher earners would grow slower than under current law. Initial benefits for someone who earned the taxable maximum throughout a career, “maximum earners,” would grow with prices (as in 1.1). Initial benefits for participants with lifetime earnings between the 30th percentile and the maximum would grow faster than prices but slower than wages; the actual benefit change would be related to the worker’s position in the income distribution.

Specifically, this would be achieved by adding a third bend point to the PIA formula within what is now the 32 percent bracket. The PIA factor would remain 32 percent below this new bend point. The PIA factors in the next two brackets would initially be 32 percent and 15 percent, but they would be reduced annually—multiplied by a rate sufficient to keep benefits for a maximum earner growing with prices, as described.

The adjustments apply to the computation of initial benefits for both retired and disabled workers, beginning in 2012. (This is the provision proposed by Robert C. Pozen.)

3. Under this provision, wages in the AIME formula as well as bend points in the PIA formula increase with prices rather than wages as under current law. This applies to both retired and disabled workers, beginning in 2012
4. This provision price indexes wages in the AIME formula for retired and disabled workers, beginning in 2012
5. This provision price indexes the bend points in the PIA formula for retired and disabled workers, beginning in 2012.

6. This provision reduces the PIA factors to reflect future changes in life expectancies at age 62. Beginning in 2012, the provision would multiply the factors by a ratio that captures the increase in life expectancy at age 62 for the each cohort as it reaches that age. For any given cohort, the ratio would equal life expectancy at age 62 for the cohort reaching age 62 in 2008 divided by the life expectancy at age 62 for the cohort reaching age 62 three years prior to the cohort in question. (For example, the ratio used for the cohort reaching age 62 in 2020 would reflect the difference between the life expectancy of the cohort reaching age 62 in 2017 and the one reaching age 62 in 2008.) The reductions apply fully to retired workers and partially to disabled workers, implemented upon conversion to Old-Age Insurance benefits at the normal retirement age and is weighted by the number of years worked prior to the onset of the disability.

## 2. Changes to Benefit Formula

1. This provision reduces the PIA factors for retired and disabled workers by 20 percent (to 72 percent, 26 percent, and 12 percent) in 2012. Under current law, the PIA factors are 90percent, 32 percent, and 15 percent.
2. This provision reduces the top two PIA factors for retired and disabled workers, from 32 percent to 20 percent and 15 percent to 10 percent, in 2012.
3. This provision reduces only the top PIA factor for retired and disabled workers, from 15 percent to 10 percent, in 2012.
4. This provision reduces the PIA factors for retired and disabled workers by 0.005 annually (all PIA replacement factors would be multiplied by 0.995 each year) beginning in 2011.
5. This provision increases the AIME calculation years for retired workers from 35 to 40, phased in over 2007 to 2011. This change applies to both the numerator and denominator of the AIME calculation; the AIME would then be the average of the 40 highest years of indexed monthly earnings. The AIME calculation change is applied only to the calculation of retired worker benefits.

### 3. Changes to Retirement Age or Actuarial Adjustments

Under the Social Security Amendments of 1983, the age at which individuals could receive unreduced Social Security retirement benefits was increased from 65 to 67 in two stages. The first stage raised the age by two months a year each year from 2000 to 2005, so that workers turning 62 in 2005 face a normal retirement age (NRA) of 66. The second stage is scheduled for 2017 to 2022, when the age will increase from 66 to 67. The period from 2006 to 2016 is the “NRA hiatus.”

1. This provision eliminates the NRA hiatus to 67, so the NRA reaches 67 for beneficiaries who turn 62 in 2011.
2. This provision eliminates the NRA hiatus to 67 and continues to increase the NRA by two months per year to age 68, so the NRA reaches 68 for beneficiaries turning 62 in 2017.
3. This provision eliminates the NRA hiatus to 67 and continues to increase the NRA by two months per year to age 70, so the NRA reaches 70 for beneficiaries turning 62 in 2029.
4. This provision raises the early eligibility age (EEA), the age at which Social Security retirement benefits can first be claimed, from 62 to 65 by two months per year beginning in 2023, so the EEA reaches 65 for beneficiaries turning 65 in 2040.
5. This provision increases the reduction factors for retired workers who apply for benefits before the NRA. The reduction factor for spousal benefits would also be increased. When the NRA reaches 67, the proposed change would have the effect of reducing the PIA for benefits at age 62 by 37 percent for retired workers (compared with 30 percent under current law) and by 42 percent for spousal benefits (compared with 35 percent under current law). This is phased in from 2008 to 2012.
6. This provision increases the delayed retirement credit (DRC) to 10 percent per year (compared with 8 percent per year under current law) phased in 0.5 percent per year from 2009 to 2015.

#### **4. Changes to COLA**

Under current law, at the end of each year, SSA adjusts benefits by the amount of any increase in the CPI. This increase is known as a cost-of-living adjustment (COLA).

1. This provision reduces the COLA applied to all benefits by 0.2 percentage points beginning in 2012.
2. This provision reduce the COLA applied to all benefits by 0.4 percentage points beginning in 2012.
3. This provision introduces a super-COLA for DI workers and auxiliaries that increases the COLA by 1.3 percentage points beginning in 2007.

#### **5. Changes to Payroll Tax Rates or Taxable Maximum**

Under current law, the OASDI payroll tax rate for both employers and employees is 6.2 percent. Payroll taxes are imposed on income up to the taxable maximum (\$90,000 in 2005).

1. This provision raises the payroll tax rate by 0.5 percentage points for both employers and employees, beginning in 2007. The increased rates total 13.4 percent: 6.7 percent for both employers and employees.
2. This provision raises the taxable maximum to cover 87 percent of earnings with additional amounts used in benefit calculations, phased in from 2007 to 2050. Currently, about 83 percent of covered earnings are taxable, and under current law the taxable maximum increases annually at the same rate as average wages in the economy. Under this provision, the taxable maximum would increase faster than average wages until 2050, when 87 percent of earnings would be taxable. Thereafter, it would increase as under current law. The additional taxable earnings would be included in benefit calculations, so workers who paid additional taxes would also be entitled to higher benefits.
3. This provision raises the taxable maximum to cover 90 percent of earnings with additional amounts used in benefit calculations, phased in from 2007 to 2100. Currently, about 83 percent of cov-

ered earnings are taxable, and under current law the taxable maximum increases annually at the same rate as average wages in the economy. Under this provision, the taxable maximum would increase faster than average wages until 2100, when 90 percent of earnings would be taxable. Thereafter, it would increase as under current law. The additional taxable earnings would be included in benefit calculations, so workers who paid additional taxes would also be entitled to higher benefits.

4. This provision raises the taxable maximum to \$250,000 in 2007, then grows it with wages in all later years, as under current law. This provision would not affect benefit calculations.
5. This provision applies a 3 percent tax on all earnings above the taxable maximum, beginning in 2007. This provision would not affect benefit calculations.

#### **6. Changes to Benefits for Low Earners**

1. This provision introduces a poverty-related minimum benefit, phased in from 2009 to 2013. A new formula for raising benefits for long-term workers with relatively low earnings would be introduced for workers becoming eligible for benefits beginning in 2009. (Current law includes a special minimum benefit, but it affects relatively few workers and is gradually diminishing in importance because it is not adjusted for real wage growth.) A new minimum PIA would be calculated based on a worker's quarters of coverage (QCs). The minimum PIA would be 2 percent of the poverty level for each QC above 40 (10 years of earnings) and up to 80 QCs, and 0.5 percent of the poverty level for QCs above 80 but not more than 160. Thus, for someone with 20 years of earnings, the minimum PIA would typically be 80 percent of the poverty level; at 40 years, the amount would be 120 percent of the poverty level. (For disabled workers, fewer quarters would be required because of their shortened careers.) Beginning in 2014, the effective poverty levels would be increased with average wages.
2. This provision increases benefits for workers who have both low lifetime average earnings and at least 20 years of covered earnings, beginning in 2007. Qualifying workers would have their PIA multiplied by the following factor:

$1 + (40.4 \text{ percent} \times \text{AIME factor} \times \text{coverage factor})$

The two factors each range from 0 to 1, so this provision increases benefit levels by up to 40.4 percent.

The average indexed monthly earnings (AIME) factor would give a larger increase to workers with lower average wages. The AIME factor is set equal to 1 for workers with an AIME equal to or less than the AIME of a worker who earned the minimum wage for 30 years. It is set to zero for workers with an AIME greater than the AIME of a “scaled medium worker” (a worker who worked for 35 years, always earning an amount equal to the AWI).

For workers with earnings between these levels the factor is set proportionately, for example, 0.5 for those at the average of those two levels. The formula is:

$$\text{AIME factor} = (\text{AIME}_{\text{medium worker}} - \text{AIME}) / (\text{AIME}_{\text{medium worker}} - \text{AIME}_{\text{minimum wage worker}})$$

The coverage factor would give a larger increase to workers with more years of covered earnings. (Years of covered earnings are defined through earned quarters of coverage.)

For most retired workers, it is set equal to 1 if the worker has at least 35 years in covered employment. It is set equal to 0 if the worker had 20 or fewer years in covered employment. For workers who worked between 20 and 35 years, the factor is set proportionately, for example, 0.6 for those with 29 years in covered employment. The formula is:

$$\text{Coverage factor} = 1 - \{[(3.5 \times \text{elapsed years}) - \text{quarters of coverage}] / (1.5 \times \text{elapsed years})\}$$

## 7. Changes to Auxiliary Benefits

1. This provision limits benefits for couples in cases where the primary worker's earnings are above the national average. Beginning in 2007 the spousal benefit would be reduced in any situation where the couple's benefit (before any actuarial reductions) would exceed the PIA of a worker who always earned the taxable maximum and reached eligibility age in the same year as the primary

earner. The spouse's benefit for these high-earner couples is limited to the difference between the worker benefit and the PIA paid to the maximum earner in that year. In an extreme case, where the primary earner has earned the taxable maximum each year, no spousal benefit would be paid.

2. This provision would reduce spousal benefits to 33 percent of the worker's benefit from the current 50 percent. This applies to both spouses of both retired and disabled workers beginning in 2007.
3. This provision boosts benefits to some surviving spouses by ensuring that benefits equal 75 percent of the hypothetical benefit that the couple would receive if both were alive. The new minimum benefit for the surviving spouse could not exceed the average PIA for retired-worker benefits in the December before the month of entitlement to the widow(er)s benefit (or, if the month of entitlement is December, then that same month). The proposed change would be implemented for those who apply for a surviving spouse's benefit beginning in 2007.

**Senate Finance Committee Hearing**  
**“Social Security: Achieving Sustainable Solvency”**  
**Questions Submitted for the Record to**  
**Dr. Douglas Holtz-Eakin**  
**May 26, 2005**

**Senator Grassley**

- Q1) We all know that Social Security has historically been financed by payroll taxes. This was the vision laid out by President Roosevelt, and it is a vision that has been followed by Republicans and Democrats alike right up to this very day. But when we talk about the tax gap, we're not just talking about payroll taxes, we're also talking about income taxes and other types of taxes. In fact, we're mostly talking about taxes other than payroll taxes. So, if we assume that Republicans and Democrats remain committed to funding Social Security through payroll taxes, and even if we assume that Congress wanted to enact all of the controversial payroll tax proposals in the Joint Tax report, how much revenue would all of the payroll tax proposals bring in—both over 10 years and on an approximate annual basis? And then maybe I could turn back to Mr. Holtz-Eakin and ask him to remind the Committee what the projected level of underfunding the Social Security system is facing today, and Members can draw their own conclusions about whether we can fix this problem by merely trying to close the tax gap.
- A) Under the projections that CBO prepared for this hearing, Social Security outlays will begin to exceed dedicated revenues in 2019. In 2040, the shortfall will be 1.6 percent of GDP, and by 2100, it will grow to 2.3 percent of GDP.

**Senator Baucus**

- Q1) As I understand it, your office developed a new Social Security baseline at the request of the Chairman of the Finance Committee that uses CBO's January 2005 short-term economic assumptions and the Social Security Trustees' 2005 long-run economic and demographic assumptions. But you also released a Social Security baseline in March, 2005 based on CBO's most current short-run and long-run economic assumptions. In the absence of a request from anyone else, is it the case that you would prefer to use the latter baseline when evaluating long-run changes to the Social Security program?
- A) The March baseline represents CBO's best estimate of Social Security's future outlays and revenues under current law. Projections will most likely be revised as modeling techniques are refined and new data become available. CBO first released a long-term Social Security baseline in June 2004 and released an update in March 2005. The projections used for this hearing, as directed by the Chairman, are based on the long-term economic assumptions used in the trustees' 2005 report. However, given the uncertainty

inherent in such forecasts, the differences between CBO's long-term economic assumptions and those of the Social Security trustees are small. For example, the trustees assume that covered wages will grow at an average rate of 1.1 percent annually; CBO assumes that growth will average about 1.2 percent. Both sets of assumptions are reasonable.

- Q2) In your testimony and during the hearing, you stated that—when considering scheduled Social Security benefits for workers with “middle earnings”—replacement rates will increase for future Social Security beneficiaries. Yet, in Figure 2-2 from CBO's June 2004 report, *The Outlook for Social Security*, replacement rates under scheduled benefits for workers with “median earnings” remain relatively constant (around 40%) beginning with the ten-year cohort born in the 1970s. Please explain this apparent discrepancy. Please include in your answer whether the apparent discrepancy is due to factors other than any possible difference between “middle earnings” and “median earnings.”
- A) Figure 2-2 from *The Outlook for Social Security* (June 2004) is reproduced in the testimony in the “Worker at Middle Earnings Level for His or Her Cohort” lines of Figure 3. The projections differ slightly because the data used in the June 2004 report differ from those used for this hearing.

The difference between the two sets of lines in Figure 3 is attributable solely to the different earnings categorizations used. One way to categorize people is to group them by a specific real earnings level, such as \$2,500 a month. Someone at that earnings level always has the same purchasing power but will fall lower in the earnings distribution over time. That categorization is used for the lines labeled “Worker at Middle Earnings Level for 2005” in Figure 3. Alternatively, workers can be grouped by relative earnings—for example, the middle 20 percent of earners in each cohort, which is the categorization used for the lines labeled “Worker at Middle Earnings Level for His or Her Cohort” in Figure 3.

- Q3) In your testimony, you describe three options for achieving solvency of the Social Security system that would last at least through the year 2100. Would you please answer the following questions:
- a) Under option 1—which is price indexing—is it the case that all benefits would decline by 25% over 26 years, and by 50% over 63 years, relative to the Social Security benefits that are now scheduled?
- b) Under option 2—which is so-called “progressive price indexing”—is it the case that middle-class workers with earnings in the middle fifth of the income distribution who are born today and retire at age 65 would have their benefits cut by more than 30% relative to scheduled Social Security benefits? Is it also the case under option 2 that low-income beneficiaries with average career earnings as low as \$15,000 would have their benefits cut relative to scheduled Social Security

benefits? Under option 2, would benefits to survivors and the disabled be cut relative to scheduled Social Security benefits?

- c) Option 3 combines changes to indexing, with other changes to the formula by which Social Security benefits are calculated that roughly mimic longevity increases that—in effect—raise the normal (full) retirement age. Under option 3, is it the case that the normal retirement age would—in effect—reach 69 by 2060 and almost 70 by 2080? Is it also the case that under option 3, the two changes in indexing would reduce benefits by 33% for low-income workers who are in the lowest fifth of the income distribution, who are born today, and who retire at age 65 relative to scheduled Social Security benefits? For similar workers in the middle fifth of the income distribution, would benefits be cut by 27% relative to scheduled Social Security benefits? Is it also the case that under option 3, benefits for survivors and the disabled would be cut relative to scheduled Social Security benefits?
- A) When comparing benefits under various proposals to those scheduled under current law, it is important to remember that under current law, scheduled benefits cannot be paid once the trust funds are exhausted; at that point, benefits will be more than 20 percent lower than scheduled. In contrast, all three of the options considered in this testimony would keep the trust funds solvent for at least the next 100 years.
- a) Relative to scheduled benefits, payments to new beneficiaries would decline by one-quarter over 26 years and by one-half over 63 years.
  - b) Under progressive price indexing, benefits for the middle earnings quintile of the cohort born from 2000 through 2009 would be about 30 percent below those currently scheduled. The higher a worker's average indexed monthly earnings (AIME), the larger the reduction relative to scheduled benefits. CBO projects that in 2012, when the changes in benefits begin under this option, the 25th percentile of the AIME distribution will be about \$1,500 in nominal dollars, equal to annual wages of \$18,000. (In 2005, the equivalent level is about \$14,000.) However, the reductions for people with AIMEs just above that level would be small. For example, by 2040, benefits for the highest earners would be 24 percent lower than under current law. But for people with AIMEs 10 percent higher than the 25th percentile cutoff—about \$1,650 in 2012—the reduction would be only 2 percent.

As estimated for this exercise, the option works by adjusting the formula used to compute the primary insurance amount (PIA). The PIA is the basis for all Social Security benefits, including disability and survivor benefits, so the option would affect all types of benefits in the same way. However, the effect of progressive price indexing depends on a worker's lifetime income, as measured by AIME. Because workers who die early or claim disability benefits tend to have lower

AIMEs than other workers, disability and survivors benefits would change less, on average, under progressive price indexing than retirement benefits would.

- c) Under current law, the normal retirement age (NRA) increases to 67 for people who turn 62 in 2022 or later. Retiree benefits equal the PIA multiplied by a factor that depends on the age at which benefits are claimed. Under current law, that factor is less than 1 for people who claim benefits before the NRA, equal to 1 for those who claim at the NRA, and greater than 1 for those who claim at later ages. Under the third option, the NRA would not be changed, but those factors would be reduced relative to current law regardless of a beneficiary's claiming age. Raising the retirement age would have a similar effect. The changes in the adjustment factors are equivalent to increasing the NRA to more than 69 for people turning 62 in 2060 and to more than 70 for those turning 62 in 2080.

**Senator Rockefeller**

- Q1) What is the more immediate fiscal problem—Social Security or Medicare? When will the Social Security Trust Fund be exhausted? And what will the financial status of the program be then? And what about the Medicare Trust Fund?
- A) Although the federal government currently spends less on Medicare than on Social Security, Medicare—like all health spending—is growing faster. Annual federal Medicare outlays are projected to exceed Social Security outlays by 2030. Under the assumptions used for this hearing, CBO projects that the Social Security trust funds will be exhausted in 2044 and that in that year, revenues will equal 76 percent of outlays. The Medicare trustees project that the Hospital Insurance Trust Fund will be exhausted in 2020 and that in that year, revenues will equal 79 percent of outlays.

**Senator Kerry**

- Q1) In your testimony, you describe three options for improving solvency. Could you describe the effects that the first two options, price indexing and progressive price indexing, would have on disability and survivor benefits?
- A) As estimated for this exercise, both options work by adjusting the formula used to compute the primary insurance amount. The PIA is the basis for all Social Security benefits, including disability and survivor benefits, so those options would affect all types of benefits in the same way. However, the effect of progressive price indexing depends on a worker's lifetime income, as measured by average indexed monthly earnings. Because workers who die early or claim disability benefits tend to have lower AIMEs than other

workers, disability and survivors benefits would change less, on average, under progressive price indexing than retirement benefits would.

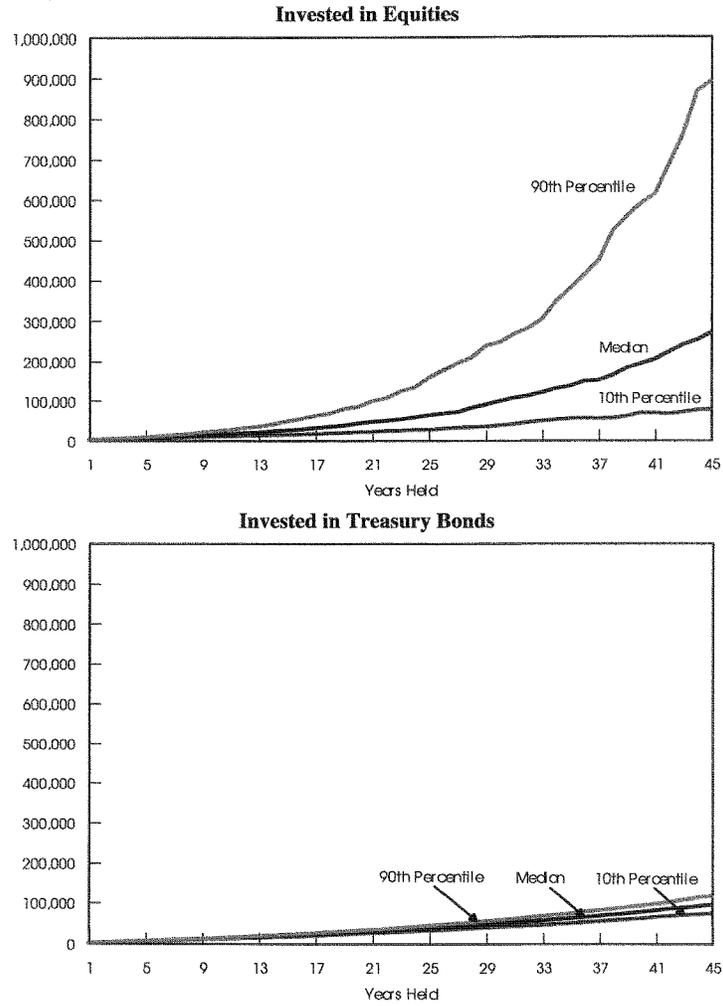
- Q2) The second option is similar to the President's progressive price indexing plan. Can you describe the differences between this option and the President's proposal?
- A) The President has not made a detailed proposal. The White House has supported "a sliding-scale benefit formula, similar to the Pozen approach." (Fact Sheet: Strengthening Social Security for Those in Need, April 28, 2005). A plan developed by Robert Pozen was described in a February 10, 2005, memo from Stephen Goss, Chief Actuary of the Social Security Administration (see [www.ssa.gov/OACT/solvency/RPozen\\_20050210.pdf](http://www.ssa.gov/OACT/solvency/RPozen_20050210.pdf)). Whereas that plan would leave the primary insurance amount unchanged for the lowest 30 percent of career-average earners, the option that CBO examined would leave benefits for the lowest 25 percent unchanged.
- Q3) On March 22nd, you spoke at the National Association for Business Economics conference and stated: "Markets recognize that the higher return on equities is compensation for the higher risk incurred." Can you expand on this and why you believe the Social Security debate would be better served if its focus were shifted away from the potential returns of private accounts invested in stock funds?
- A) The use of risk-adjusted returns informs the debate about trade-offs in Social Security reform, but those returns are not a predictor of accumulations in investment accounts. To see why, note that CBO assumes that over the long term, the average real return on equities will be 6.8 percent. However, equity returns are subject to a great deal of volatility—in CBO's analysis, there is about a 10 percent chance that the return in a given year could be less than -18 percent and a 10 percent chance that it could be more than 37 percent. Assuming that an individual invested \$1,000 annually for 45 years, an average return of 6.8 percent would translate into roughly \$270,000 in today's dollars. However, at the upper end, there would be a 10 percent chance that the accumulation would be \$900,000 or greater, and on the downside, there would be a 10 percent chance that the accumulation after 45 years would be less than \$76,000 (see Figure 1). In short, although the average rate of return is 6.8 percent, the investment risk inherent in equities translates into considerable variation in total possible accumulation.

In contrast, consider Treasury securities. CBO assumes that they will yield a 3.3 percent real return annually. They are also subject to much less volatility. As a result, a similar comparison of total accumulation over 45 years varies much less (see Figure 1). The median projection is about \$98,000, but there is a 10 percent chance of accumulating more than \$120,000 and a 10 percent chance of accumulating \$75,000 or less.

Figure 1.

**Balance of an Account with a \$1,000 Annual Investment**

(Real dollars)



Source: Congressional Budget Office.

That is the kind of information about *outcomes* that documents the trade-offs between risk and return and that informed investors should seek, financial advisors should provide, and consultants should give their clients.

A very different question is “What should I do *now*?” Looking at a range of outcomes does not indicate whether a person would buy equities, put dollars into Treasury securities or seek a mix. In the context of Social Security, a beneficiary might have to decide to take up a voluntary individual account and effectively make a tradeoff between the account and Social Security annuities in the future.

How do people make those kinds of decisions? Every individual will have an internal yardstick for tolerating additional risk to gain additional expected returns. For purposes of analyzing Social Security—a government program—it is appropriate to use a broad, market-based measure that shows how much compensation individuals demand, in the form of higher returns, to induce them to hold the equities that have higher risk. Or, put another way, people are willing to hold Treasury bonds to avoid exposure to risk that they find undesirable.

Thus, financial markets are useful for providing information about how individuals place value *now* on those alternative futures displayed in the two graphs. One alternative future has a higher return and a wide range of outcomes. The second has essentially a single path into the future. Financial markets tell us how to put those outcomes on a level playing field by noting that the risk-adjusted rate of return, the Treasuries’ 3.3 percent, is the current valuation of both futures—it makes people indifferent between holding equities or holding Treasury bonds.

In sum, risk-adjusted returns do not predict the likely accumulation of accounts in the future. Instead, they are a useful yardstick of value to put trade-offs on a level playing field. For example, they help inform how to trade off traditional annuities and individual accounts in a voluntary setting. They also inform budgetary trade-offs both within Social Security and between Social Security and other government programs.

#### Senator Schumer

- Q1) Dr. Holtz-Eakin, let me follow up on this issue of risk. I know that you are aware of the Web-based Social Security calculator that my office created, which is also on the Web sites of many Democratic senators. Some have criticized our calculator for using a risk-adjusted rate of return for the private accounts, as opposed to simply plugging in a number for the average annual return in the stock market. Several Nobel-prize winning economists, the investment firm Goldman Sachs, and even CBO have analyzed Social Security privatization proposals based on this notion of a risk-adjusted rate of return. Could you please explain to the Committee why this figure is the appropriate one to use, as opposed to average stock market returns?

- A) As noted in the final answer to Senator Kerry, risk-adjusted rates of return are useful in providing valuations that permit trade-offs to be viewed on a level playing field. However, they are not the best predictors of the actual outcomes of investments. Thus, to the extent that the calculator is used to present trade-offs between take-up of voluntary accounts and traditional Social Security annuities, risk adjustment is useful.

Statement of Stanford G. Ross  
Before Senate Committee on Finance  
May 25, 2005

Chairman Grassley, Senator Baucus, and Members of the Committee, I thank you for the opportunity to testify on achieving sustainable solvency in Social Security. This is an important subject and I commend the Committee for trying to pursue this goal at this time. I hope I can be helpful by presenting a viewpoint informed by many years of experience working within the system.

I am a former Commissioner of Social Security under President Jimmy Carter, Public Trustee of the Social Security and Medicare Trust Funds under Presidents George H.W. Bush and William Clinton, and Chairman of the Social Security Advisory Board under Presidents William Clinton and George W. Bush. I was confirmed to all these posts by the Senate after being approved by this Committee. I have been intimately involved with the Social Security system in these capacities for more than 25 years and have appeared before this Committee many times.

I care deeply about the Social Security system and believe that it is important to resolve the current financing issues in a way in which the system can maintain the broad public support it needs and restore confidence that its goals of providing reliable income replacement for the elderly, disabled and their dependents and survivors can be sustained.

Social Security Institutions

One of the most disturbing parts of the discussion of Social Security reform to date has been the undermining of confidence in institutional arrangements such as the integrity of the Trust Funds. I think it is important for the public to understand that the Treasury obligations held by the Social Security Trust Funds are backed by the full faith and credit of the United States like any other obligation of the Treasury. In fact, the bonds held by the Trust Funds receive a preferred rate of interest and are entirely equivalent in value and security to those held by the public.

The institutions surrounding Social Security have evolved over a long period. The independence of the actuaries, the annual reporting, and other governance arrangements such as an independent Social Security Advisory Board and the presence of independent public trustees, are all important protections for the public.

The rancor in the present discussion of Social Security is unprecedented. For nearly 70 years since its enactment, the Social Security system has been broadly supported by Republican presidents and administrations as well as Democratic presidents and administrations. Bipartisan approaches supporting Social Security were taken under Presidents Eisenhower, Nixon, Ford, Reagan and George H.W. Bush. The present

Administration is the first Administration that has suggested that the concepts underlying the system are inherently flawed. In fact, the concepts underlying the system are sound and the values they reflect of providing income protection for the elderly, the disabled, and their spouses and dependents on a universal, contributory basis are widely shared by Americans.

Moreover, the institutions that have evolved to implement these concepts work well. That is why we know the amount of deficits and what must be done to remedy them. The Congress has received early warning on an annual basis of the problems for many years and there is no reason to distrust the long-term viability of the system if the Congress takes appropriate and timely legislative action. Up until now, the Congress over 70 years has always done what was necessary to protect the American public's interests in a sound Social Security system, and there is no reason to doubt that it will do so once again.

#### Proceed on a Bipartisan Basis

To my mind, there is only one effective way to address Social Security solvency issues – develop a legislative package on a broadly bipartisan basis. This will inevitably involve compromise and a willingness to give respect and recognition to a variety of viewpoints. There is no better place for work on bipartisan approaches to begin than in this Committee with its tradition of cooperation and comity among members.

#### Agree on the Size of the Deficit

The first task is to reach a consensus, if possible, on the dimensions of the problem. The Social Security Actuaries' 75-year projection is of a deficit equal to 1.92% of payroll. The Congressional Budget Office's comparable figures on a 75-year projection are that there is a deficit of 1.05% of payroll. It would be helpful if these two projections could be reconciled and, if possible, there was a common projection or at least a clear explanation of the differences. Projections vary based on assumptions and methodologies and it is quite possible that there could be reasonable differences based on varying views on these matters. But clarification is needed as the process moves forward to help policymakers reach agreement on the size of the deficit.

While the SSA-CBO difference is relatively large, even accepting the Social Security Actuaries' projection, the problems of the Social Security system, while serious, can be addressed in a considered manner and do not, to my mind, present a crisis. We have solved problems of this dimension before. The deficit situation present in 1983 could be viewed as a more difficult challenge because of the imminence of the lack of funds to pay benefits. In the present situation, it will be several decades before a point of disruption in benefit payments is reached. Nonetheless, it would be better to address the financing issues sooner rather than later because the changes that are needed can be less drastic and the transitions for changes can be implemented in a more measured manner. Hopefully, this Congress, responding to the priority given to this issue by the President, will address the subject and resolve it on a basis that lasts for the indefinite future.

Before leaving this first issue of establishing the dimension of the problem, I should note that some in the Administration have suggested that the solvency problem should be resolved based on projections based on an infinite horizon. This would be a new departure since in the past the 75-year projections of the Social Security Actuaries have always been used. Importantly, it would appear to make the problem that must be addressed considerably larger and more difficult to resolve. The infinite horizon projection of SSA shows a deficit of about 3.6% of payroll. This projection, while perhaps useful for some purposes, is not to my mind useful from the standpoint of developing a legislative package. It is not the traditional approach of the Office of the Actuary and is not generally accepted by the actuarial profession for use in this context.

Since I think the important goal of the Congress ought to be to resolve the solvency issue of Social Security, I will approach the problem assuming there is to be no diversion of revenue from the traditional Social Security system to establish individual accounts. As discussed below, the individual account system suggested by the Administration would appear to worsen the deficit by about 0.6% of payroll and make achieving sustainable solvency considerably more difficult. I will also assume the target should be the 1.92% of payroll deficit based on the Social Security Actuaries 2005 Report, although the Committee may well decide a smaller figure is appropriate based on the CBO projections. I also assume the need to meet the SSA Actuaries' tests that sustainable solvency is indicated if the trust fund ratio is projected to be (1) positive throughout the 75-year projection period and (2) either stable or raising at the end of the 75-year period.

#### Construct a Balanced Package of Changes

Historically, a bipartisan approach in this type of situation has developed a balanced package of revenue enhancements and benefit adjustments. This is the approach that was taken by the Congress in 1983 when the most recent solvency legislation was enacted. It was also the approach taken in 1977 and, indeed, in 1972 when benefits were indexed for inflation and the attempt was made, unsuccessfully, to place the system on a basis that would be sustainable automatically for the indefinite future without the need for periodic legislation to adjust the system.

Some would say that a balanced package of incremental changes that would allow compromises on a bipartisan basis is mere "tinkering" with the system. I suggest, however, that this is a misunderstanding of what is inevitably involved in changing a large system like Social Security. Every change affects many people over very long periods and relatively small, incremental changes that are well designed and carefully implemented are the best way to change a big system. This is true not only in the United States, but across countries. Large changes often produce unintended consequences and harsh results that can undermine public support. Therefore, based on the history of this system and its critical importance to all Americans, I would strongly recommend the same approach that has been taken in the past – a balanced package of incremental changes.

### Possible Revenue Enhancements

On the revenue enhancement side, there is one obvious possibility for change. The 1983 changes were based on about 90% of earnings being covered by the system. In recent years, coverage has been reduced to about 83%. This is partly because of the greater dispersion of income in recent years in the United States, and partly because of the increasing amounts of non-cash income, such as in-kind benefits, but 90% is still a useful standard to reestablish for the system. According to the Social Security actuaries, restoring the maximum earnings base over a ten-year transition period would produce about 0.75% of payroll, roughly 40% of the projected deficit.

Another possible revenue enhancement would be to increase the administrative resources of IRS to close the part of the so-called annual tax gap of \$350 billion attributable to Social Security taxes, perhaps \$55 to \$65 billion per year. While in the context of tax reform legislation, improved administration has generally not been scored as a revenue producing item, we should examine whether in the context of long-term Social Security projections that it might be treated as a revenue enhancement in the same way as adding non-cash benefits into the earnings base is credited.

Another possibility is to tax Social Security benefits in a manner similar to private pension income. The lower income thresholds would be phased out over a ten-year period. Such a change would produce about 0.33% of payroll. Because the income tax is structured to not tax lower income workers, they would not be affected. In this regard, it should be noted that when taxation of Social Security benefits was last changed, the increased funds were directed to the Medicare Trust Fund. However, it should be recognized that it would be more appropriate to have this money from taxing Social Security benefits recycled into the Social Security Trust Fund to be available for payment of Social Security benefits. Changes in the taxation of benefits would be controversial and might be hard to reach bipartisan agreement on, but as a matter of policy, taxation is a far better approach to reducing benefits for upper income earners than other suggestions that have been made such as progressive indexing, which lack a policy rationale, as discussed below.

Thus, there are a variety of possible changes that could provide revenue enhancements of about 0.96% of payroll, roughly one-half of the projected deficit.

### Possible Benefit Adjustments

The second part of any bipartisan package will involve benefit adjustments. I use the word adjustments, rather than benefit cuts, in this context advisedly. I think any changes in the structure of benefits ought to be done in a way that makes them more efficient and improves fairness.

From this standpoint, I would not make major changes to indexing. The indexing system that has been arrived at historically, which is basically wage indexing up to the time of setting the initial benefit and price indexing thereafter, is sound. This system evolved after much study. The reason for wage indexing of initial benefits is to make

sure the benefit is in line with economic conditions at the time that a person moves from worker status to retired status. The reason for price indexing of benefits after someone is in retirement is that the purchasing power of their benefits should be kept up to date.

It would be particularly inappropriate to change the indexing in calculating the initial benefit from wages to prices. This would deprive workers of improvements in the economy over the period of their working lives. So-called "progressive indexing" would be even worse because it would discriminate among various workers and result in long-term distortions in the structure of benefits. Thus, too many middle and upper income workers would ultimately receive a flat benefit and the universality of the program would be lost. It would be far better if there were to be an attempt to introduce more progressivity into the system to tax more of the benefits in the same manner as with private pensions, as discussed above.

There may be ways to improve the accuracy of Social Security cost of living adjustments. There is a new CPI that takes additional account of consumer behavior and is viewed by many as a superior measure of purchasing power. Although it would be controversial since there are other viewpoints, this change would reduce the deficit by 0.35% of payroll and would be entirely in accord with the income replacement goals of the program.

Another possibility for adjusting the benefit structure would be to change the formulas for calculating initial benefits. Thus, the number of years used to calculate benefits could be increased from 35, the present number, to 38 or 40 and phased in over an appropriate period of five to eight years. These kinds of changes would save from 0.26% to 0.42% of payroll and would be entirely in accord with the goals of existing formulas to produce an appropriate replacement for earnings over the entire working life. In this regard, a credit for years spent outside the paid workforce doing childcare would be in order. Further changes in the benefit structure to reduce the bend points and replacement factors are also possible but hopefully would not be needed to achieve solvency.

One change in the benefit structure that would not be in order at this time would be a major change in the retirement age, which was raised from 65 to 67 in 1983 with a protracted phase-in. Until the labor markets adapt to show that older workers will be able to work longer, further changes in the retirement age are simply a way to cut benefits. The benefits cut would likely affect the more vulnerable, those less able to work in older age. As discussed above, there are better ways to adjust benefits. However, eliminating the existing hiatus in the normal retirement age by speeding up the transition to the increase to age 67 which was enacted in 1983 would be in order and could save approximately 0.14% of payroll.

It could be that further increases in the retirement age would be necessary and appropriate in the longer run to maintain solvency. The actuarial test for solvency requires stable or rising trust fund rates at the end of the 75-year projection period. People are living longer and the system may need to be adapted to those circumstances in the future.

When approaching the benefit adjustments, the present structure of spousal benefits should be reviewed and appropriate changes should be made. At present, spouses get an automatic 50% of the higher earner's benefit. This can be seen as discriminatory vis a vis working spouses and lower income spouses. While benefits can be viewed on a family basis, something like earnings sharing or other methods of dividing benefits could be developed to achieve greater fairness.

Another change that would increase costs but would be desirable would be to develop a minimum benefit that protects low-income workers. A worker with a full lifetime of work should receive a benefit that provides sufficient income to avoid poverty.

It would also be helpful if service delivery issues at the Social Security Administration, particularly with the disability program, could be more forcefully addressed. At present, there are often long waiting lines at Social Security offices and inadequate telephone service. Processing of disability claims can take years. The independent Social Security Advisory Board, while I was Chairman, documented the presence of these issues and they need to be corrected as promptly as possible. The public deserves better service. Thus, more resources should be furnished to SSA to improve benefit delivery structures as part of the implementation of the legislative package that is constructed.

To summarize, once a figure is reached for remedying the deficit, a package of incremental changes involving revenue enhancements and benefit adjustments should be constructed that increases the efficiency and fairness of the system. An illustrative legislative package is attached to this statement.

#### Individual Accounts

If individual accounts were set up on a carve-out basis that would divert revenues from the traditional Social Security system, and would make the deficit in Social Security finances more difficult to solve. Although a complete actuarial analysis has not yet been provided, the plan for individual accounts suggested by the Administration would appear to increase the deficit by a considerable amount, around 0.6% of payroll. It would also greatly increase public debt, around five trillion dollars over the first twenty years. And it would make fundamental social security benefits inordinately subject to market risk.

If at the point that a solvency package is achieved, the Congress were to decide to introduce an individual account system into the legislative package, it could be done on a fully financed and fiscally sound add-on basis. The best approach here could be along the lines that the late Senator Moynihan, a former Chairman of this Committee, once suggested, which would be simple 2% add-on accounts, 1% contributed on a voluntary or mandatory basis by the worker with a matching 1% by the government, with subsidization of lower income workers. Of course, if there was a general budget surplus, this approach would be more feasible than at a time when large deficits are being run and there are no government funds available for a matching contribution to provide workers with an incentive to enter the new system.

An additional set of considerations that has largely been absent from the debate to date about Social Security individual accounts involves administrative issues and implementation of any changes. Countries that have introduced an individual account system have usually needed to change and adjust it very rapidly. Just as this country had difficulty when it introduced the indexing of benefits in 1972 and correcting it required the Congress to return to the subject fairly promptly because of the inadequacies of the first approach, this need to revise is almost inevitable with a complicated subject like individual accounts. Some countries have done it so badly, such as the United Kingdom, that they have both damaged their fundamental income replacement protection and, after several attempts at reform, not produced an individual account system that adequately makes up for the erosion of the basic coverage of their state pension system. Even a small country such as Sweden, which took a great deal of time and introduced the system on a nonpartisan basis, in the sense that all political parties agreed to the changes, had difficulty with various aspects of implementation.

Given the general fund deficits and the difficulties that would inevitably be involved in implementation of a new system, it might be better for the time being to improve the treatment of 401(k)'s and IRA's as a way of encouraging additional savings for retirement. Thus, automatic 401(k) accounts, which would reduce some of the complexity for individuals to participate might well increase private savings. Similarly, there could be improvements in the structure of IRA's to make them more useful. While none of this is necessary to include with a Social Security reform package that is designed solely to return long-term sustainable solvency to the system, it would be a useful addition if it were fully financed, for example, by being part of a fiscally balanced set of tax changes.

#### Conclusion

I strongly urge embracing a broadly bipartisan approach to construct a legislative package of incremental changes to restore financial solvency. If, in the current political environment, it is difficult for the Congress to achieve this directly, it might consider appointing a commission along the lines of the 1983 Social Security Commission, which included Members of Congress, or the recent 9/11 Commission. The President's Commission to Strengthen Social Security was constrained by its mandate to make recommendations that included, among other guidelines, individual accounts, and its membership reflected a limited number of viewpoints. In contrast, a broadly bipartisan commission with a clear mandate to achieve sustainable solvency and a membership that was reflective of a broad spectrum of viewpoints could usefully produce an agreed set of facts and recommendations for the Congress to consider. If such a commission were set up in the near future, it could be given a year to report and then the Congress would have a basis for legislation next summer. If the Congress were unable to reach agreement on the basis of such a broadly bipartisan report, the elections in the fall of 2006 could provide a public referendum on the issues addressed.

I will be happy to help the Committee and its members in any way I can and, once again, I thank you for the opportunity to be here today.

Illustrative Legislative Package to  
Eliminate SSA Deficit Projection of 1.92%\*

Possible revenue enhancements

Restore covered earnings to 90%	0.75
Tax social security benefits in a manner similar to private pensions; or enhanced collection of payroll taxes	<u>0.21</u>
	0.96

Possible benefit adjustments

Make CPI formula more accurate	0.35
Increase number of years to calculate benefits from 35 to 40	0.42
Eliminate hiatus in reaching normal retirement age of 67 and increase retirement age in future as necessary	0.14
Revamp spousal benefits, add minimum benefit, and other changes in benefit formulas	<u>0.05</u>
	0.96

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\* If the targeted deficit is 1.05% (CBO), fewer of the changes listed above would be needed. It is important to note that calculating the effects of possible changes are complex and are only an approximation until an actual package is prepared. These calculations are for illustrative purposes and based on the 2004 SSA Trust Fund Reports and a February 7, 2005 memorandum of the SSA Office of the Actuaries that scores possible individual changes without taking into account their interactions.

Stanford G. Ross is a lawyer/consultant based in Washington, D.C. He has served (1997-2002) as Chairman of the Social Security Advisory Board, an independent bipartisan agency of the U.S. government that advises the President, the Congress, and the Social Security Administration on pension and income protection issues. He has previously served as Commissioner of Social Security (1978-79), and as Public Trustee of the Social Security and Medicare Trust Funds (1990-95). He has dealt extensively with public policy issues while serving in the U.S. Treasury Department, on the White House domestic policy staff, and as General Counsel of the Department of Transportation.

Mr. Ross has provided technical assistance on social security and tax issues under the auspices of the International Monetary Fund, World Bank and U.S. Treasury Department to various foreign countries. He has taught courses on social security and taxation under the auspices of the OECD for officials from Central and Eastern European countries. He has participated in programs on social protection systems for developing countries sponsored by the International Social Security Association and APEC/Asian Development Bank.

Mr. Ross is co-author of a recent IMF Working Paper (December 2004) entitled: "Integrating a Unified Revenue Administration for Tax and Social Contribution Collections: Experiences of Central and Eastern European Countries." He is the author of "Doctrine and practice in social security pension reforms," in *International Social Security Review*, Vol. 53, No. 2 (2000) and "Political and social aspects of international tax policy in the new millennium," in *Brooklyn Journal of International Law*, Vol. XXVI, No. 4 (2001).

Mr. Ross is an Honorary Advisor and Founding Member, and a former Director and President, of the National Academy of Social Insurance.

Mr. Ross has taught at the law schools of Georgetown University, Harvard University, New York University, and the University of Virginia, and has been a Visiting Fellow at the Hoover Institution, Stanford University. He has served as Chairman of American Bar Association Tax Section committees and on the Advisory Committee for the federal income tax laws of the American Law Institute. He received his J.D. from Harvard Law School and his B.A. from Washington University (St. Louis).

**Answers to Questions Submitted for the Record From Stanford G. Ross  
Finance Committee Hearing of May 26, 2005**

***Senator Rockefeller***

I am sorry that I missed the testimony because of a commitment I had at the Intelligence Committee. I did notice that in your written testimony, Mr. Ross, you noted with dismay that this is the first administration to suggest that our Social Security system is inherently flawed. This disturbs me as well.

I hope that you would expand on your thoughts about how the concepts underlying the system are sound, and what concepts are the most essential to protect as we deal with solvency.

**Answer**

The concepts underlying the Social Security system that, I believe, are sound and most essential to protect are as follows. First, the system provides a modest benefit that can be the foundation of support in retirement. The present system replaces about 40 percent of prior earnings for the average worker, and, when the retirement age of 67 is fully phased in, this will probably be reduced to about 35 percent. This is among the lower replacement rates of developed countries, but provides a foundation of support that is essential to maintain. It is important that this be a guaranteed benefit and not subject to market fluctuations as it would be if individual accounts supplied all or part of this foundational benefit. It is also important that opportunities be provided on an individual basis to achieve greater savings for retirement so as to have greater income. Second, it is important that the program be universal and contributory, as it is.

***Senator Kerry***

1) In your written testimony, you mentioned that an additional set of considerations which involves administrative issues and implementation of any changes has largely been absent from the debate about Social Security. Could you describe these administrative issues and the type of changes that would need to be implemented, and the impact these would have on small businesses?

**Answer**

The principal administrative issues relate to implementation of changes by the Internal Revenue Service and Social Security Administration, assuming private accounts are along the lines of the suggestions of the administration to date, which seem to use the

Thrift Savings Plan as a model. Both of these government organizations have been inadequately funded in the recent past and have no existing capacity to take on new challenges such as implementation of an individual account system. Both of these agencies would require considerable additional resources, particularly in the area of systems and information technology and additional specially trained personnel. Even assuming the material and human resources are supplied promptly and adequately, problems should be anticipated. The experience of every country in the world that has introduced one of these systems is that even with adequate planning and provision of resources, there are inevitable problems that require continued revisiting of the subject and cooperation by the Executive Branch and the Legislative Branch. Thus, it is important that if an individual account plan is to be implemented it have broad bipartisan support that can sustain it during the 5- to 10-year period that likely will be needed to make it operate soundly.

Small businesses have problems presently with withholding on employment taxes, and these would be augmented if there were additional withholding for an individual account system. Increased enforcement and taxpayer assistance would be needed to make sure that there was full compliance by small businesses with the demands of an individual account system.

2) In your testimony, you advocate the need of a bipartisan solution to address Social Security solvency. Do you believe private accounts need to be taken off the table before real discussions can begin on Social Security reform?

**Answer**

As I said in my testimony, it would be better if private accounts were off the table so that full focus could be on the solvency issues of the basic system. But it is conceivable that, once the solvency issues are addressed, private accounts could be included in the legislative package as an "add-on" to enable workers to save additional amounts for their retirement, provided such an add-on system were fully funded and fiscally sound, so that it did not deprive the basic system of needed resources.

3) The President has now put forth two proposals to reform Social Security: private accounts and progressive price indexing. What is the combined effect of these proposals on the 75-year shortfall?

**Answer**

Private accounts would greatly increase the deficit. Progressive indexing would reduce the deficit. The combined effect of these proposals is hard to determine until the administration presents a full plan for reform of the Social Security system with a comprehensive actuarial study. To date, a full plan has not been presented nor has a comprehensive actuarial study been furnished, so that any projection of the combined

effect of these proposals, and presumably other elements that would be needed to have a full proposal, are difficult to determine.

*Senator Schumer*

1) Mr. Ross, in your testimony, you mentioned that the President's plan for private accounts would make Social Security benefits "inordinately subject to market risk." This is an issue that has come up repeatedly, but up until now it's been hard to quantify exactly what that means. According to CBO's analysis, equity portfolios will do worse than Treasury portfolios about 15 percent of the time for people who are 35 years or more from retirement, and anywhere from 15 to 25 percent of the time for people 15 to 35 years from retirement. In other words, more than 15 percent of the people would be expected to lose money in their private accounts.

Do you think this is an acceptable amount of risk? Supporters of the President's plan may spin this to say that the majority of people will be better off. I was hoping you could explain to the committee why this perspective is problematic for an insurance program.

**Answer**

I think that a basic benefit at the level of about 35-percent replacement rate, which is what the system will provide once the new normal retirement age of 67 is fully phased in, should not be subject to any market risk. It should be a guaranteed benefit that can be a basic foundation for retirement planning. Market risk can be introduced by IRAs, 401(k)s, and other forms of savings to augment the basic benefit, which should be guaranteed.

2) Mr. Ross, you alluded to the 1983 Social Security Commission as a model we ought to use again to improve the solvency of the Social Security system. Some individuals have criticized the reforms enacted in 1983 as being temporary adjustments that did not address long-term solvency. Yet, in my view, the Commission did pretty well. Since the reforms enacted in 1983 will be viable until at least 2041 and possibly until 2052, it appears that the 1983 Commission took a system that would have become insolvent in a matter of months and made it sustainable for 60 to 70 years. That's not half bad. Is there any reason that today's circumstances, 20 years later, would prohibit the same kind of resolution?

**Answer**

I think with the benefit of hindsight, the 1983 Social Security Commission's approach can be improved upon. It is possible to make the system solvent over a 75-year projection period and to ensure that it will not immediately or shortly thereafter go back into deficit, which was not an issue that was adequately addressed in 1983. To this end, the SSA

actuaries have added a second test that the trust fund ratios at the end of the 75 years be stable or rising. Provided that this second criterion is met, there should not be the problem that was encountered with the 1983 Commission's approach.

3) Mr. Steuerle talks a lot in his written testimony about how the eligibility ages for Social Security should be adjusted. Do you think it would be possible, as one element of reform, to adjust the eligibility ages depending on the type of work performed during workers' lifetimes? For example, someone who did physical work would be eligible to receive benefits at a lower age than someone who did mostly white-collar work, and the age could be slightly different for each worker depending on how many years of each type of work they did during their lives. Obviously, we could only do such a change prospectively. Would such a change be too complicated? Would it be inequitable? I'd like to hear your views on this.

**Answer**

It would be difficult to try to categorize workers by the nature of their activity as physical workers or white collar workers. However, by offering an early retirement age and an adequate minimum benefit, the workers themselves can adapt the system based on their personal capacities. It is conceivable that if the retirement ages for normal retirement and early retirement have to be raised in the future in order to achieve solvency, then it will become more important to have a minimum benefit, and it will be important to review the disability program to make sure that it can take care of workers who have a physical or mental condition that does not allow them to make it to the early retirement age or the normal retirement age. These are issues, however, that can be best dealt with by general rules rather than trying to categorize workers by the nature of their activities during their working lives.

**SOCIAL SECURITY**

Statement before the  
Committee on Finance  
United States Senate

May 25, 2005

C. Eugene Steuerle

C. Eugene Steuerle is a senior fellow at the Urban Institute, codirector of the Tax Policy Center, and a columnist for *Tax Notes Magazine*. Any opinions expressed herein are solely the author's and should not be attributed to any of the organizations with which he is associated.

**SOCIAL SECURITY REFORM**

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify on achieving sustainable balance in Social Security. Since Social Security was first enacted, vast changes have occurred in the economy, life expectancy, health care, the physical demands of jobs, the labor force participation of women, and even the age at which one can be considered old. Yet, we often debate Social Security as if the type of system we want in 2080 should be determined by perceptions and measures of society's needs in 1930, or 150 years earlier. Much of my testimony will deal with our increasing inability to protect the young, the truly old, and the vulnerable when Social Security morphs into a middle-age retirement system.

The Social Security debate could and should be part of a larger one in which we engage our fellow citizens in figuring out how to take best advantage of new opportunities created by longer lives and better health. How can we spread the gains from this increased level of well-being and wealth to create a stronger nation with opportunity for all? And how should we share the costs?

Unfortunately, as now scheduled, the legacy we are about to leave our children is a government whose almost sole purpose is to finance our own consumption in retirement. We who are middle-aged or older come nowhere close to paying for the government transfers we are scheduled to receive, especially once health benefits are added in. More important, we plan to pay for them by shrinking almost to oblivion the rest of government that would serve our children and grandchildren.

The impact on the budget is especially large beginning around 2008 because that is when so many start moving from the working-age population into the retired population. Assume merely that Social Security, Medicare, and Medicaid continue on automatic pilot, that interest on the debt is paid, and that as a percentage of GDP existing levels of revenues are allowed to rise only moderately and defense expenditures decline only modestly. Then by about 2015 no revenues are left for anything else—not for justice or transportation or education, not for wage subsidies or education or environmental clean-up or community development, not for the IRS or national parks—not even to turn on the lights in the Capitol. The pressure on the budget is not awaiting some magical date like 2018 or beyond. Social Security and Medicare are already spending much more than the Social Security tax for Social Security and Medicare, and even this accounting does not include all the other programs for the retired and elderly in the budget. The pressure on programs for children and working families is being felt right now, and the fight over the fiscal 2006 budget makes this glaringly apparent.

Clearly, retaining a necessary share of the budget for our children and grandchildren means that we must pare the growth rate in elderly entitlement programs. Nonetheless, I believe that *it is possible under existing tax rates to build a Social Security system that would do a better job than the current one at removing poverty (measured by relative living standards) and serving the majority of the population when they are truly*

*old.* If we start with that type of base, then we can move onward to the other debates—those over how to increase private retirement saving, how many benefits should be provided to those who are middle-aged, and how much higher benefits need to be for those who are better off.

#### **MEASURING LIFETIME BENEFITS**

Looking at Social Security reform through an annual lens often distorts the impact of longer lives and more years of benefits on the costs of the system and the rate of benefit growth. A more comprehensive and more revealing approach, I believe, is to look at the lifetime package of benefits.

Define “lifetime benefits” as the value, at age 65, of Social Security and Medicare benefits as if they were sitting in a 401(k) account that would earn interest but be drawn upon over retirement. In today’s dollars, lifetime benefits for an average-income couple have risen from about \$195,000 in 1960 to \$710,000 today (\$439,000 in Social Security and \$271,000 in Medicare) to over \$1 million for a couple retiring in about 25 years (over \$1/2 million in both Social Security and Medicare—see figure 1). These numbers quickly reveal what is happening to the budget as a whole. We cannot provide a very large portion of American couples \$1/2 to \$1 million of benefits and simultaneously encourage them to drop out of the workforce for the last third of their adult lives without affecting dramatically the services that can be provided through the budget to our children and to working families.

#### **THE SIMPLE ARITHMETIC DRIVING SOCIAL SECURITY REFORM**

Despite the confusing aspects of trust fund accounting, rates of return, and financial measures of solvency, the arithmetic behind Social Security’s current problems is simple. Once the baby boomers starting hitting retirement, there is a scheduled drop in workers per beneficiary from more than 3-1 to less than 2-1. To simplify our arithmetic, let us assume that the drop is exactly from 3-1 to 2-1, and imagine that this drop were to occur instantaneously. Recall that Social Security is almost entirely a pay-as-you-go system, despite a slight and temporary buildup in trust funds that ultimately would pay for only around one-tenth of liabilities under current law. Now consider three workers, A, B, and C, who each transfer \$3,333 and 1/3 to pay \$10,000 of benefits to D (figure 2). All of a sudden C disappears, so only A and B must pay the benefits of D. A and B can continue to pay \$3,333 each. But then D would receive only \$6,666 in benefits. Thus, her benefits would fall by one-third. Or D can be held harmless, so that she still receives \$10,000. But then A and B would have to increase their payments to \$5,000 each. If we must hold at least one group harmless, then what is required is either a benefit cut of 33 percent or a tax rate increase of 50 percent.

### **A MIDDLE-AGE RETIREMENT SYSTEM SERVING THE VULNERABLE LESS EACH YEAR**

Social Security's current dilemma centers almost entirely on the drop in scheduled workers per retiree—a labor force issue. Although more saving would be nice, whether in trust funds or retirement accounts, we are not going to save our way out of this problem. Consider some of the consequences of the current system.

*The system has morphed into a middle-age retirement system.*

- Close to one-third of the adult population is scheduled to be on Social Security within about 25 years. Including adults on other transfer programs, we are approaching the day when the majority of the adult population will depend upon transfers from others for a significant share of its support.
- People already retire on average for close to one-third of their adult lives.
- The average Social Security annuity for a man retiring at 62 lasts 17 years, for a woman 20 years, and for the longer living of a couple at least 25 years. The life numbers are even higher for those with above-average lifetime earnings because they have above-average life expectancies.
- When Social Security was young—for instance, in 1940 and 1950—the average worker retired at about age 68. To retire for an equivalent number of years on Social Security, a person would retire at age 74 today and age 78 in another 60 years (figure 3).

*Almost every year a smaller share of Social Security benefits goes to the most vulnerable.*

- By constantly increasing benefits to middle-age retirees, at least as defined by life expectancy, smaller and smaller shares of Social Security benefits are being devoted to the elderly (figure 4). If progressivity is defined by how well the vulnerable are served, the system is becoming less progressive every year.

*The economy gets hit several ways, not just in terms of costs.*

- Among the most important, but ignored, sides of the Social Security budget equation is the decline in growth of the labor force (figure 5), with its additional effect on slower growth in national income and revenues.
- When a person retires from the labor force at late middle age, national income declines. But the decline is borne mainly by other workers, not by the retiree. For instance, when a \$50,000-a-year worker retires a year earlier, national income declines by approximately \$50,000, but most of those costs are shifted onto other

workers as the retiree starts receiving about \$23,500 in Social Security and Medicare benefits (much more in the future) and pays about \$18,300 less in taxes (figure 6).

- Saving declines because people retire in what used to be their peak saving years. For instance, when a person retires for 20 years versus 15, he both saves for 5 years less and spends down his or society's saving for 5 years more.

### **THE OPPORTUNITY: INCREASING WORKSPANS WHILE PROTECTING THE VULNERABLE**

Believe it or not, there is tremendous opportunity in all of this. People in their late 50s, 60s, and 70s have now become the largest underutilized pool of human resources in the economy. They represent to the labor force for the first half of the 21st century what women did for the last half of the 20th century. The labor demand, I believe, will be powerful, and it is mainly our institutions, public and private, that are blocking us from making full use of these valuable and talented people.

Keep in mind that this labor force story differs dramatically from that of the past 60 years. Two factors made the remarkable decline in labor force participation among older men possible: the entry of the baby boom population into the labor force and the increased labor force participation of women. The net effect over the post-World War II period was an adult employment rate that increased over almost all non-recession years (figure 7). What this tells me is that there is a demand for labor that very possibly would be met by this extraordinary pool of talented older workers if institutions adjusted to encourage it and let it happen.

We don't really know yet how all of this will play out. But if we remove the disincentives to work, increased labor force participation could make all sorts of budget decisions easier over the long run. Again, it is because increased labor will add both to national income and to revenues—thus lessening how drastically programs for the young AND the old have to be cut.

### **RE-ORIENTING BENEFITS TOWARD THE OLD**

Restoring Social Security to an old-age, not a middle-age, retirement program can be done partly by increasing the retirement ages (including the early retirement age—else it is just an across-the-board benefit cut). A related move would be to backload benefits more to help those who are older. Whatever the level of lifetime benefit settled upon in a final reform package, actuarial adjustments can provide more benefits later and fewer earlier. These adjustments can take various forms: adjust benefits upward when Social Security predicts that average life expectancy has fallen below, say, 12 years (about age 74 in 2005 and indexed for life expectancy in later years) and downward in earlier ages; or provide a lower up-front benefit in exchange for post-retirement wage indexing.

A related adjustment would be to provide a better actuarial adjustment for working longer. Currently we subsidize people to retire early. While lifetime benefits are about the same for a worker retiring at, say, age 62 or 65 or 68, the worker who stays in the workforce contributes much more in the way of tax. A greater differential between earlier and later retirement would be appropriate both from a fairness and an efficiency standpoint.

These changes in retirement ages and in the lifecycle distribution of benefits have many positive effects. They progressively move benefits to later ages when people have less ability to work, lower income, and less help from a spouse to deal with impairments. Support in old age WAS the original purpose of the program. They put labor force incentives where they are most effective—in late middle age, including the 60s, when most people report being in fair, good, or excellent health. When cuts in benefit growth rates are required, they cause less hardship than almost any across-the-board benefit cut for two reasons: first, they are more likely to increase revenues, thus making it possible to afford a better benefit package, and second, they don't affect the benefits of the truly old as long as they adjust their work lives in line with the changes in the retirement ages.

I recognize that some people are concerned about groups with shorter-than-average life expectancies. But attempting to address their needs by granting many of us who are healthy a 20th and 21st and 22nd year of transfer support and tens, if not hundreds, of thousands of dollars in extra benefits for retiring early is a very bad form of trickle-down policy.

An increase in the retirement age can be combined with other provisions that help, rather than hurt, groups with shorter life expectancies. One way to do this is to provide a minimum benefit aimed at lower-income households and at reducing poverty rates (using a poverty standard adjusted for living standards or wage-indexed) among the elderly. With such a minimum benefit in place, any of the age-of-retirement adjustments can actually increase, rather than decrease, the relative share of benefits for groups with lower life expectancies, since their life expectancies are correlated with lower lifetime earnings. In fact, with a good minimum benefit, we can increase the income of low-income people and reduce poverty rates, even relative to current law.

One warning is in order here, however. Some minimum benefit packages end up more symbol than substance. For instance, they may not be indexed for wages, so don't cost much in the long run. Or they have so many years of work requirement that they don't help some groups of low-income people, especially women. We need Social Security and other agencies to provide estimates of the effectiveness of different alternatives if we want to provide a base of protection.

#### **EVIDENCE ON ABILITY TO WORK**

One question that often arises is whether Social Security needs to provide an increasing share of benefits every year to those further and further from date of expected death. Three pieces of evidence are provided here: (1) health trends among old and near-

old; (2) physical demands of jobs; and (3) the ability of people to work at similar ages in the years before early retirement options and other benefits were made available.

First, older Americans over age 55 seem to be reporting that their health has improved. Figure 8 reports the share of older adults reporting fair or poor health in two groups: those age 65–74 and those age 55–64 between 1982 and 2002. Even among those age 65–74, the fraction reporting fair or poor health is less than one-quarter. The fraction actually reporting poor health is much smaller still. The rest report being in good or excellent health.

Similarly, among those age 55 to 59, the share with work limitations has declined from 27.1 percent in 1971 to 19.5 percent in 2002 (figure 9). Note that a work limitation does not mean inability to work but, rather, a limitation to do certain types of jobs. In any case, the trend moves in the same direction: as years pass, fewer people of a given age have been reporting work limitations.

Survey results such as those just reported, of course, involve qualitative data. We need to check alternative evidence. A second approach is to try to find trends in physical limitations of jobs using a similar measure over the years. One source, shown in figure 10, indicates that the share of U.S. workers in physically demanding jobs has declined from over 20 percent in 1950 to about 8 percent in 1996.

Finally, let us compare the labor force participation of males with a similar life expectancy from 1940, when Social Security first paid benefits, until 2001. In figure 11, we see that about 86 percent of men with about 16 years of life expectancy participated in the labor force in 1940. That figure remained high until the late 1960s, a few years after men with a similar life expectancy became eligible for early retirement benefit and after Medicare benefits were enacted into law. After those enactments, labor force participation began a very rapid descent to less than 35 percent. It is now beginning to rise slowly—one more piece of evidence that demand for labor is shifting to older workers.

It is hard to believe that as the physical demands of jobs have declined, people have become that much less capable of working. It is more likely that the higher levels of benefits in Social Security and Medicare, increasingly available for more and more years before expected death, have been the major factors driving the drop in labor force participation.

## **CHANGING THE DEFAULT**

Under current policy, federal government spending grows automatically, by default, faster than tax revenues as the population ages and health costs soar. These defaults threaten the economy with large, unsustainable deficits. More important, they deny to each generation the opportunity to orient government toward meeting current needs and its own preferences for services. Only by changing the budget's auto-pilot

programming can we gain the flexibility needed to continually improve government policies and services.

Rudolph L. Penner (also a senior fellow at the Urban Institute and a former director of the Congressional Budget Office) and I have come to believe that there is no way to get the budget in order without addressing the issue of these defaults. Budget-irresponsible defaults apply to many programs of government, but the largest are linked to Social Security and Medicare. As currently structured, these programs are designed to rise forever in cost faster than national income and revenues—an impossible scenario. In Social Security, the problem is caused by the combination of more years of retirement support over time and wage indexing for annual benefits.

Regardless of what Social Security reform is undertaken, some rule should be adopted that would put the program back into balance over the long term when, for instance, the trustees report for three consecutive years that the program is likely to be in long-run deficit. This trigger should force the system's automatic features to move responsibly back toward budgetary balance.

With the trigger pulled, two of many options at that point strike me as particularly simple and easy to implement. First, the early and normal retirement ages could be automatically increased two months faster per year than under current law for everyone younger than, say, 57 in the year the trigger is pulled. Second, in those years, the benefit formula could be indexed to the lower of price or wage growth in a way that allows average real benefits to increase but more slowly than wages.<sup>1</sup> This approach could be supplemented by a new special minimum benefit indexed to wage growth. Other approaches to this option can also be devised to reduce the growth rate of benefits more for high earners than for low earners.<sup>2</sup>

Of these two options, I prefer increasing the retirement ages since that allows more revenues for the system and, consequently, higher lifetime benefits for the same tax rate. Other benefit reductions, as noted, hit the oldest beneficiaries with their greater needs as well as everyone else. For similar reasons, among the “progressive price indexing” options, I prefer creating a wage-indexed minimum benefit since that is more likely to protect the more vulnerable, including survivors, than is a form of progressive price indexing that continues to spend larger shares of revenue on increasing benefits for succeeding generations of those with well-above-median lifetime earnings. But, regardless, the system must be redesigned so that, when on automatic pilot, the default option leads to a responsible and sustainable budget.

There is, of course, no reason to believe that such automatic changes will alone lead to a socially optimum Social Security system. For instance, they do not deal with the

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<sup>1</sup> Technically, the so-called bend points in the benefit formula could be indexed to the lower of wage or price growth. This approach to price indexing differs from some recent proposals that ratchet down future benefits derived from the current benefit formula by the difference between the rate of growth of wages and prices.

<sup>2</sup> The term “progressive price indexing” has sometimes been applied to this effort, but there are many ways to change the growth rate differentially for workers with different levels of lifetime earnings.

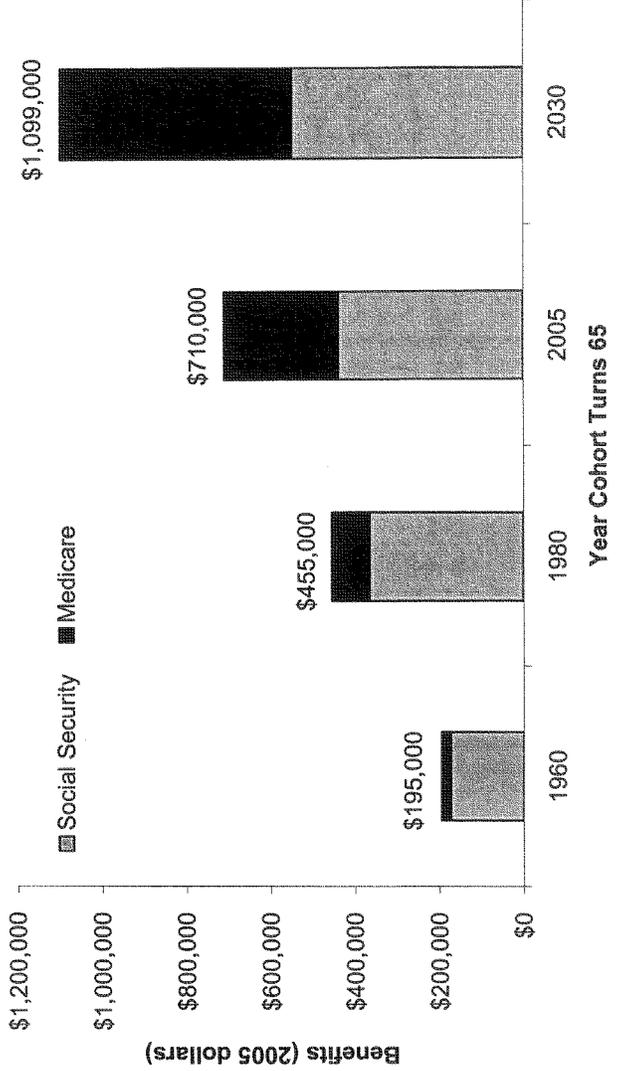
discrimination in current law against single heads of households. The point of changing the defaults is, rather, to migrate from a system in which the Congress has little choice but to enact painful benefit cuts to one in which Congress has the opportunity to provide more generous benefits from time to time—that is, to play tax Santa Claus rather than Scrooge sometimes, as politics requires.

By creating a system in which the budget automatically becomes ever more responsive and responsible to future taxpayers and beneficiaries, the door is also open to spending more now on programs for people who aren't elderly—especially children—and on public investments. Or Congress might use the freed-up resources to make Social Security benefits more generous to those with low average lifetime earnings or to provide more cash to lower-income elderly to help pay for medical payments. And, of course, Congress can always choose to raise taxes to provide a higher benefit growth rate in each year, though remaining responsible means making each year's decision to increase benefit levels independent of the next year's.

#### **CONCLUSION**

We can and should fix a Social Security system that favors middle-age retirement and that continually reduces both the shares of Social Security resources for the truly elderly and the share of total revenues remaining for programs for children and working families. A reformed system can easily reduce poverty rates (adjusted for life expectancy), while providing many others among the truly old a lifetime benefit as good, or better, than most generations have received in the past.

Figure 1  
**Social Security and Expected\* Medicare Benefits for Average-Wage,  
 Two-Earner Couple (\$36.6K each)**



\* Expected rather than realized benefits. Notes: The "high" and "average" wage profiles are those hypothetical profiles routinely employed by the Social Security Administration in its analyses. Lifetime amounts, rounded to the nearest thousand, are discounted to present value at age 65 using a 2 percent real interest rate and adjusted for mortality. Projections based on intermediate assumptions of the 2005 OASDI and HI/SMI Trustees Reports. Includes Medicare Part D. Source: Adam Carasso and C. Eugene Steuerle, The Urban Institute, 2005.

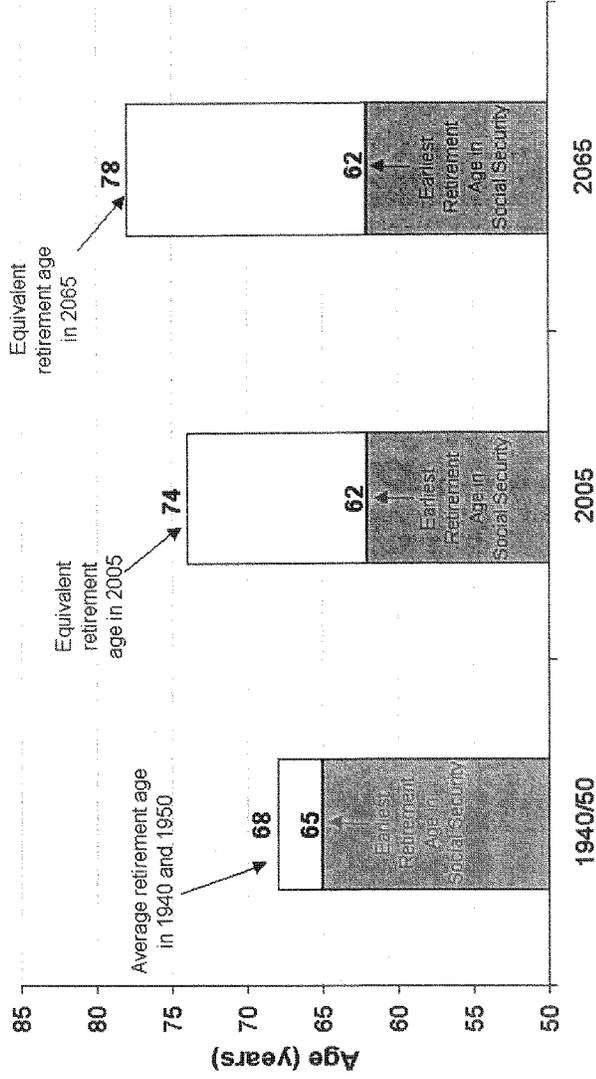
Figure 2

Simple Example			
Effect of a Drop in Workers to Beneficiaries From 3-to-1 To 2-to-1			
Taxes Paid By Taxpayers			Benefits per Beneficiary
A	B	C	D
Pre-Baby Boomer Retirement			
\$3,333	\$3,333	\$3,333	\$10,000
Post-Baby Boomer Retirement - Hold Taxpayers Harmless			
\$3,333	\$3,333	\$0	\$6,666 (33 percent reduction in annual benefits)
Post-Baby Boomer Retirement - Hold Beneficiaries Harmless			
\$5,000 (50 percent increase in tax rates)	\$5,000 (50 percent increase in tax rates)	\$0	\$10,000

Source: C. Eugene Steuerle, "The Simple Arithmetic Driving Social Security Reform." *Economic Perspective Column*, Tax Analysts. April 20, 1998. Available online at <http://www.urban.org/url.cfm?ID=1000085>.

Figure 3

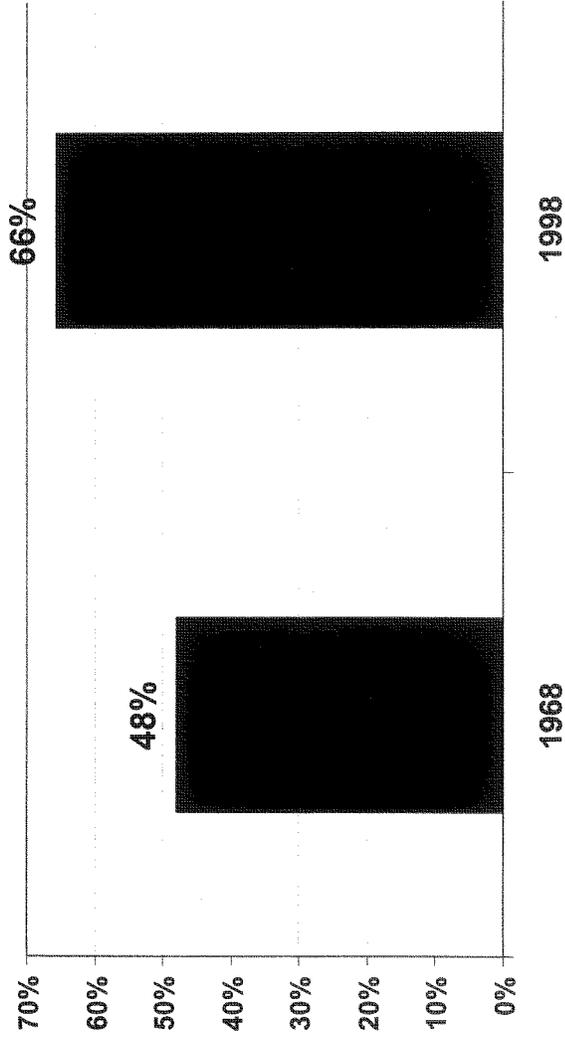
### Retirement Age and Life Expectancy, 1940/50, 2005 and 2065



Source: The Urban Institute, 2005. Based on data from the Social Security Administration, Birth Cohort Tables, 2005.

Figure 4

Proportion of Men's Social Security Benefits Going to Men  
With More Than 10 Years Remaining Life Expectancy



Source: C. Eugene Steuerle and Adam Carasso, *The Urban Institute, 2002*. Based on data from the Social Security Administration's 2001 Annual Statistical Supplement, Table 5A.1.

Figure 5

## Labor Force Projections

### Annual Growth Rate (% over Period)

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2000-10	2010-20	2020-30
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1.08

0.38

0.38

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Note: Projections assume no change in patterns of retirement by age and sex.

Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Based on data from the US Bureau of Census and Labor Statistics.

Figure 6

**For a worker who earns \$50,000...**

<b>Increases in Resources Transferred from Others</b>	
Social Security Benefits	\$18,500
Medicare Benefits	\$5,000
<b>Total 1</b>	<b>\$23,500</b>
<b>Decrease in Resources Transferred to Others</b>	
Social Security Taxes	-\$7,700
Federal Income Taxes	-\$6,600
Other Taxes (Including State and Local)	-\$4,000
<b>Total 2</b>	<b>-\$18,300</b>
<b>Net Change in Transfers Received (Total 1 - Total 2)</b>	
	<b>\$41,800</b>
Addendum: Additional decline in retiree's after-tax earnings otherwise available to meet current and future needs	
	\$31,700

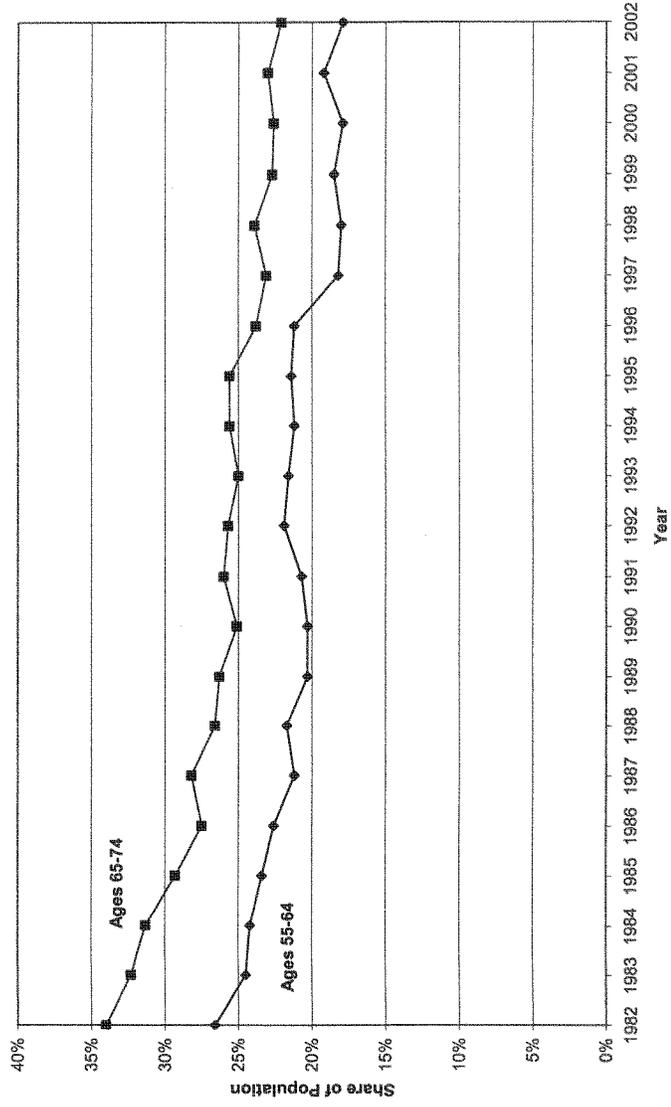
Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002.

Figure 7  
Labor Force Participation Rates: Males and Females Aged 55+ vs. the  
Adult Population, 1948-2004



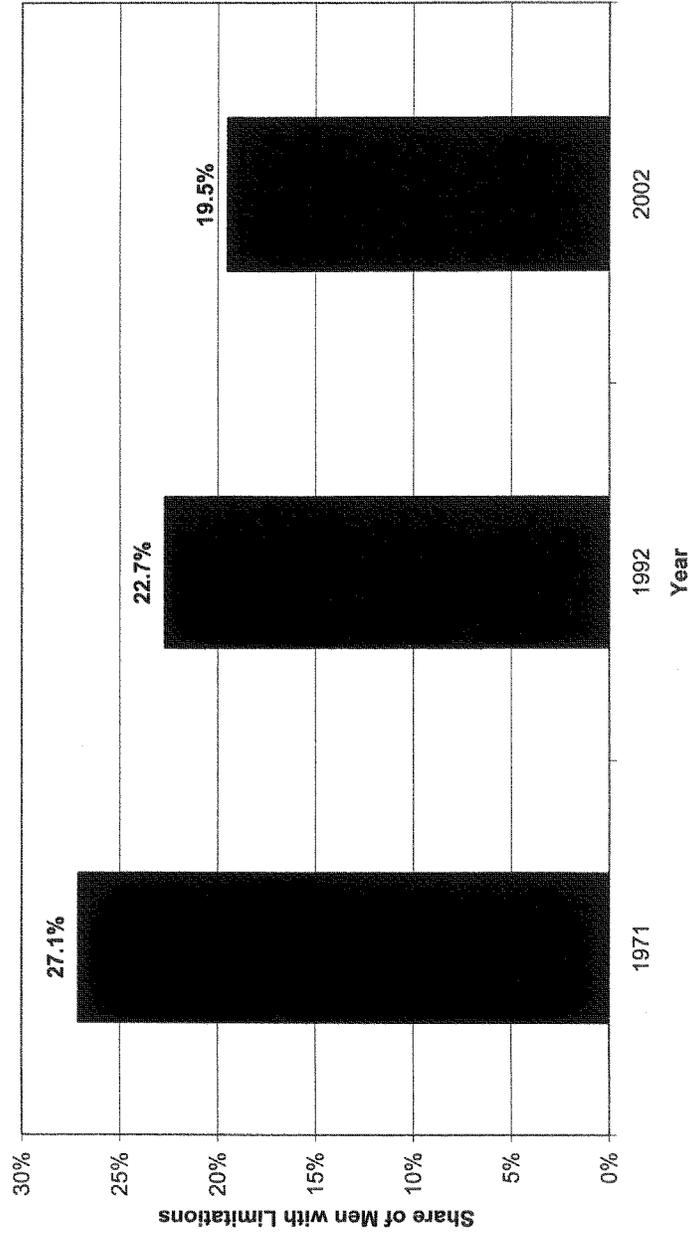
Source: U.S. Bureau of Labor Statistics, 2005.

Figure 8  
Share of Older Adults Reporting Fair or Poor Health, 1982-2002



Source: National Center for Health Statistics (2004).

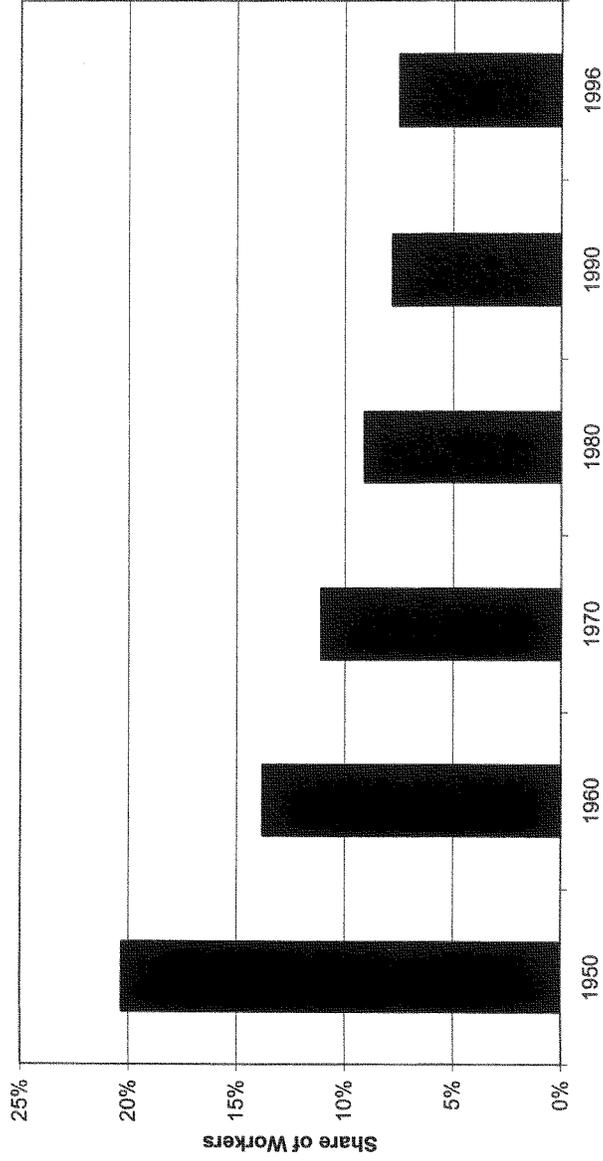
Figure 9  
Share of Men Ages 55-59 with Work Limitation, 1971, 1992, 2002



Source: Richard Johnson and C. Eugene Steuerle, "Promoting Work at Older Ages: The Role of Hybrid Pension Plans in an Aging Population," Pension Research Council Working Paper 2003-26. Available online at [http://www.urban.org/UploadedPDF/410932\\_promoting\\_work.pdf](http://www.urban.org/UploadedPDF/410932_promoting_work.pdf). Estimates from the National Longitudinal Survey of Older Men and the Health and Retirement Study.

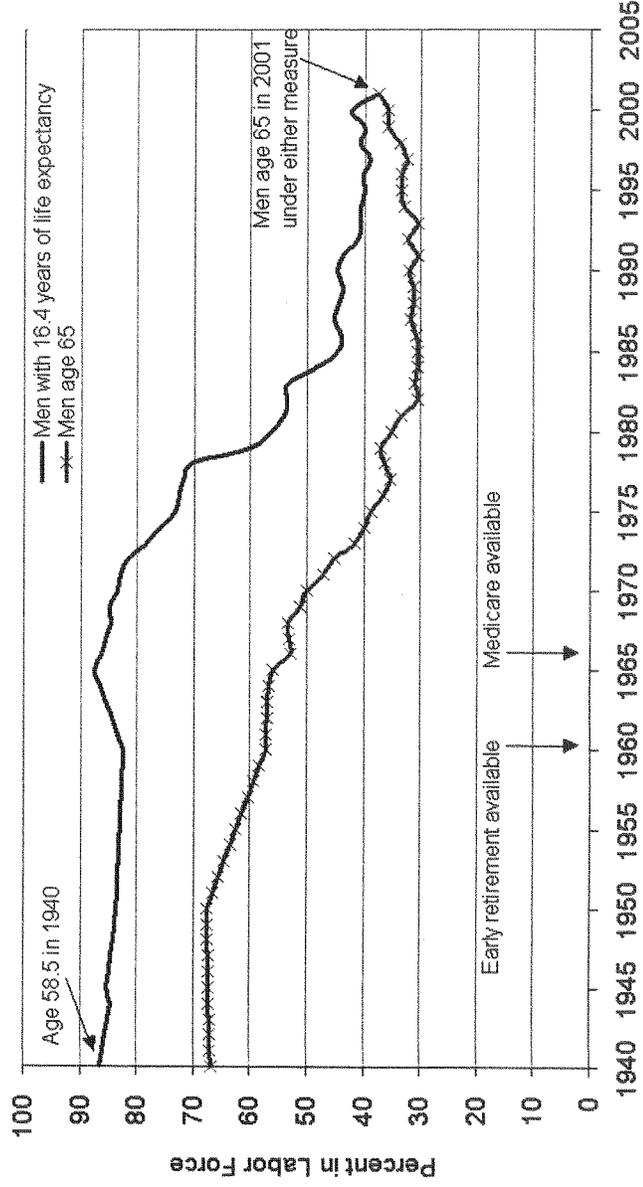
Figure 10

Figure 9. Share of U.S. Workers in Physically Demanding Jobs



Source: C. Eugene Steuerle, Christopher Spiro, and Richard Johnson. "Can Americans Work Longer?" *Straight Talk on Social Security*, No. 5, The Urban Institute, August 15, 1998. Based on the U.S. Department of Labor, *Dictionary of Occupational Titles* (1977) and the U.S. Bureau of the Census Current Population Survey, 1971, 1981, 1991 and 1997. Data points for 1950 and 1960 are taken from the U.S. Social Security Administration study *Increasing the Retirement Age: Effect on Older Workers in Physically Demanding Occupations or Ill Health*, 1986.

Figure 11  
Male Labor Force Participation Rates, 1940-2001



Source: C. Eugene Steuerle, Adam Carasso and Meghan Bishop, The Urban Institute, 2002. Based on data from the U.S. Social Security Administration, the Bureau of Labor Statistics, and the U.S. Census of Population.

**Responses to Questions for the Record From Dr. C. Eugene Steuerle  
Senate Finance Committee Hearing of May 25, 2005**

**Questions from Senator Baucus**

Question 1. It is quite obvious you have given a lot of thought to private retirement systems. I'd like to ask you about some of your ideas for the private savings system. I've been very interested in automatic enrollment and expanding the Savers Credit. Could you explain your ideas on those two matters and why you think such changes are important?

**Answer to Question 1**

I believe there is large and growing evidence that retirement saving increases as options become easier and more automatic, also as the process is eased for intermediaries (both employers and financial intermediaries). One piece of evidence came when individual retirement accounts (IRAs) were limited for high income individuals, and there was a remarkable drop-off in percentage of the remaining eligible people who then took IRA deductions. In this case, the banks and other financial institutions simply were not able to easily tell applicants that they were eligible (e.g., the institutions didn't know whether the individuals would have a sufficiently low level of adjusted gross income (AGI) by the end of the year.

Despite similar tax incentives, participation in 401(k) plans has always been well in excess of participation in IRAs, even for people eligible for both. People also accept standards and practices set within the workplace, and are influenced by employer information. They clearly indicate higher participation in systems where they have formally to opt out instead of opting in. Another important option is to automatically increase rates of deposit out of wages as wages increase over time. In part, lethargy – taking the time to examine and change choices – is a great predictor of behavior. That is, people often do not take the time to opt in or opt out or change their deposit rates, so the setting of the default policy is all important. Legal experts tell me that “opt out” types of policies are probably allowable under current law, but then pension experts complain that even if something appears to be legal, companies can still get sued anyway under tax laws, labor laws, and age discrimination laws. Here Congress may want to provide some additional security against such lawsuits.

Question 2. I wonder if you can explain a little further your idea of giving employers safe harbor protection from lawsuits about benefits if they hire or retain older workers. Are you suggesting changing today's antidiscrimination rules and, if so, what specific changes do you have in mind?

**Answer to Question 2**

Today's antidiscrimination laws operate in strange ways to economists simply trying to measure whether employees are being paid the same total compensation for the same job. Traditional defined benefit plans, for instance, provide much higher benefits relative to

cash pay for the same job for different types of workers. Particularly favored are longer-term workers who are approaching maximum number of years of eligibility. Below that level and past that level, the percentage of pay paid out in benefits is often much lower. Or course, this also creates a set of incentives for employers, who are given an incentive to abandon a plant or move jobs elsewhere if their workforce is in a high pension accrual stage.

The age discrimination laws now on the books do not deal well with these issues, and they do not apply well to younger workers or much older workers. Another complication is that the tax laws sometimes state that pension money cannot be paid until one retires. Many employers try to get around that requirement by playing a game of allowing people to retire, then hiring them back but in some slightly different type of job or at fewer hours or as a consultant, and only after they have been away for awhile.

Employers again fear lawsuits if they try to set up plans differently for different types of workers. But, for instance, an older worker may cost more in health benefits and more (or less) in retirement benefits based on age, time until vesting and withdrawal, and other factors. At times the law almost seems to imply that economic discrimination (paying different age people different amounts for the same job) is okay and at other times that legal discrimination can be assessed even when the employer is attempting to avoid economic discrimination. It is a minefield for employers and employees alike. Yet I believe that there will be large and substantial demand for older workers, which has begun already but will accelerate as soon as the baby boomers start retiring.

Much of this is explained in the accompanying study, which I attach in both its shorter and longer versions.

#### **Question from Senator Schumer**

Mr. Steuerle, you talk a lot in your written testimony about how the eligibility ages for Social Security should be adjusted. Do you think it would be possible, as one element of reform, to adjust the eligibility ages depending on the type of work performed during workers' lifetimes? For example, someone who did physical work would be eligible to receive benefits at a lower age than someone who did mostly white-collar work, and the age could be slightly different for each worker depending on how many years of each type of work they did during their lives. Obviously, we could only do such a change prospectively. Would such a change be too complicated? Would it be inequitable?

#### **Answer**

I am not sure how one would make adjustments according to the type of job that a person has. There is no standard definition of type of work performed, I believe, that has adequate legal standing, even though we may use it for approximate purposes when conducting statistical studies. Even then, the firm one works for does not tell a lot about such items as physical demands. Someone moving boxes at a retail store may have a more physically demanding job than someone pushing computer buttons at a steel mill. Over time both may also move from job to job within the firm and among firms, and I

have no idea how one would grant different retirement ages to the person who worked at a steel mill for 20 years and then at a retail store the next 5 years versus someone who did the opposite.

Nonetheless, I think there are other ways of dealing with the issue of how to treat those workers who might have shorter life expectancies because of harder work. One is to make adjustments not on the basis of type of work but on lifetime earnings. In general, those with lower lifetime earnings are likely to have shorter life expectancies. A good minimum benefit could insure that there was no loss, on average, in lifetime benefits for the typical lower-income individual even if retirement age were increased. Yet another possibility would be to set a maximum benefit amount that could be received at early ages, say, from 62 to the normal retirement age. In effect, this would provide an incentive for work in those years, but only to the extent of benefits above some threshold. For lower-income workers whose benefit fell below that threshold, in effect, there would be no change, and for slightly higher income workers, the change would be modest. The largest effect would be for those with higher lifetime earnings.

Still, as people live longer and longer, and life expectancy at age 62 starts increasing toward and beyond two decades, we must face up to the fact that 62 or 65 is middle age, not old age. The power of this signal to people should not be discounted.

In sum, I think adjustment by type of work performed would be complicated to administer and probably inequitable, but there are other ways of achieving what I believe to be the objective of this proposal.



JOINT COMMITTEE ON TAXATION  
May 25, 2005  
JCX-38-05

**TESTIMONY OF GEORGE K. YIN  
CHIEF OF STAFF  
OF THE  
JOINT COMMITTEE ON TAXATION**

**AT A HEARING OF THE SENATE COMMITTEE ON FINANCE ON  
"SOCIAL SECURITY: ACHIEVING SUSTAINABLE SOLVENCY"**

**May 25, 2005**

Mr. Chairman, Senator Baucus, members of the Committee, thank you for inviting me to testify today. I have been asked to present to the Committee various tax legislative changes that might be adopted to improve the solvency of the Social Security system. After a brief summary of current law, I will describe possible changes to the employment tax base and certain options relating to the employment tax rate and cap. I have included in my testimony very preliminary revenue estimates of most of the options presented, assuming they are implemented in 2006 with no transitional relief or phase-in. These estimates reflect the most recent baseline provided by the Congressional Budget Office ("CBO") and, with respect to options to expand the employment tax base, include outlay effects associated with the impact of the proposals on Social Security and Medicare benefits as provided to the Joint Committee staff by CBO.

**Summary of Current Law**

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA"). A similar tax is imposed on the net earnings from self-employment under the Self-Employment Contributions Act ("SECA").

The FICA tax consists of two parts: (1) old-age, survivor and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base (\$90,000 for 2005) (the "tax cap"). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

Similarly, the SECA tax has two components. Under the OASDI component, the rate of tax is the combined employer and employee rates under the OASDI portion of FICA (12.4 percent). Under the HI component, the rate is the combined employer and employee rates under the HI portion of FICA (2.9 percent). The OASDI portion of SECA tax is subject to the same limit as under FICA, i.e., this component is capped at \$90,000 of self-employment income (for 2005). The amount of self-employment income subject to HI taxes is not capped.

For SECA tax purposes, net earnings from self-employment generally include gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business. Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gain or loss from the sale or exchange of a capital asset, from timber and certain mineral property, or from other property that is neither inventory nor held primarily for sale to customers.

#### **Possible Changes to the Employment Tax Base**

Before considering possible employment tax rate changes or an increase to the employment tax cap, the Committee should examine areas in which the employment tax base is not comprehensive. Distortions created by exceptions to the base may be exacerbated if they are permitted to continue with an increase in tax rates or the tax cap. Set forth below are a number of possible ways to improve the comprehensiveness of the employment tax base. Almost all of these options were included in the recent Joint Committee staff report on "*Options to Improve Tax Compliance and Reform Tax Expenditures*."<sup>1</sup> As you know, this report was prepared in response to a request from the Chairman and Ranking Member. A detailed description and analysis of these options may be found in the published report.

#### **1. Modify Determination of Amounts Subject to Employment Tax for Partners and S Corporation Shareholders**

Present law provides different employment tax treatment of individuals who are owners of interests in passthrough entities and perform services in the business. S corporation shareholder-employees are treated like other employees, and therefore their wages from the corporation are subject to FICA tax. In contrast, a broader category of income of general partners, that is, the partners' distributive share (whether or not distributed) of income from any trade or business carried on by the partnership, is subject to SECA tax. The distributive share of income of limited partners is generally not subject to employment tax, and the employment tax

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<sup>1</sup> Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005. The report proposes a number of options relating to FICA and SECA taxes. The proposals relating to FICA may have the effect of increasing FICA taxes imposed on some employers and employees. Likewise, the proposals relating to SECA taxes may have the effect of increasing SECA taxes for some individuals. In the case of individuals whose earnings equal or exceed the OASDI taxable wage base without regard to a proposal, only HI tax will apply to the additional earnings that result under the proposal. The FICA and SECA proposals will result in increasing revenues for the Social Security and Medicare programs. In addition, requiring additional amounts to be subject to FICA and SECA taxes may increase benefits for some individuals, as well as long-term costs under such programs.

treatment of partners who are neither limited nor general partners is uncertain. These differences may cause a taxpayer's choice of business form to be motivated by a desire to avoid or reduce employment tax, rather than by nontax considerations.

Certain of these distinctions arise as a result of outdated State law concepts. For example, because State law historically prohibited limited partners from performing services for their partnerships, their share of partnership income, except for guaranteed payments received by the partner for services rendered, was not made subject to SECA tax. Many State laws no longer have this limitation. In addition, there is much uncertainty caused by the widespread use of limited liability companies ("LLCs"), which are generally treated like partnerships for Federal tax purposes. Some LLC owners may view themselves as comparable to limited partners for employment tax purposes and some may take the position that neither SECA nor FICA tax applies.

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages, but generally is not subject to employment tax on the shareholder's distributive share of income. It has become increasingly common for individuals who perform services in businesses that they own to choose the S corporation form to seek to reduce their employment taxes. S corporation shareholders may pay themselves wages below the tax cap, while treating the rest of their compensation as a distribution by the S corporation in their capacity as shareholders.<sup>2</sup> They may take the position that no part of their S corporation distributive share is subject to employment tax. While present law provides that the entire amount of an S corporation shareholder's reasonable compensation is subject to FICA tax in this situation, enforcement of this rule by the government may be difficult because it involves factual determinations on a case-by-case basis.

Under the proposal in the Joint Committee staff report, the present-law rule for general partners generally applies to any owner of a partnership or S corporation (including a general or limited partner, an owner of an LLC treated as a partnership for Federal tax purposes, and a shareholder of an S corporation) for SECA tax purposes. Thus, all such owners are generally subject to SECA tax on their distributive shares (whether or not distributed) of the entity's income. As under present law, specified types of income are excluded from SECA tax, such as certain rental income, dividends and interest, certain gains, and other items. However, under the proposal, in the case of a service entity, all of the owner's net income from the entity is treated as net earnings from self-employment.<sup>3</sup> If any owner does not materially participate in the trade or business of the entity, a special rule provides that only the owner's reasonable compensation from the entity is treated as subject to SECA tax. Thus, some general partners who are subject to

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<sup>2</sup> Because the HI component of the FICA and SECA taxes has no wage cap, this approach may be viewed as a tax planning opportunity with respect to HI tax even at higher wage levels.

<sup>3</sup> A service entity is an entity, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to Internal Revenue Code sec. 448(d)(2)).

SECA tax on their distributive shares of partnership income under present law will be subject to SECA tax only on reasonable compensation from the partnership under the proposal.

The conceptual premise of the proposal is that the base for FICA and SECA taxes is labor income. The proposal applies this notion more uniformly than does present law to individuals who perform services for or on behalf of a passthrough entity in which they own an interest (i.e., a partnership, limited liability company, or S corporation). The proposal treats such individuals similarly to sole proprietors, as well as similarly to each other. Not only does this more uniform treatment improve the fairness of the tax law and increase the internal consistency of the tax rules, it also tends to improve tax neutrality by reducing the importance of FICA and SECA tax differences in taxpayers' choice of business entity.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by \$36.3 billion, increase off-budget revenues by \$28.2 billion, and increase outlays by \$0.5 billion, for a net increase in revenues of \$64 billion overall.

## **2. Impose Withholding on Certain Payments Made by Government Entities**

IRS studies have consistently shown that the underreporting of compensation income by sole proprietors and others not subject to wage withholding is the single largest contributor to the tax gap. To address this problem, the Joint Committee staff report includes a proposal to impose withholding on certain government payments for goods and services that are not currently subject to withholding. Because such payments represent a significant part of the economy, the proposal can be expected to improve compliance to a significant extent without burdening any private sector payors. The proposal thus attempts to balance the goals of improving compliance and not creating undue administrative burdens. The proposal exempts smaller governmental entities from the withholding requirement.

This proposal can be expected to increase income tax and employment tax revenues, both by collecting some tax from the transaction and by stimulating voluntary reporting and payment of tax apart from any amounts actually withheld. Other proposals in this area have been suggested which would impose withholding in additional situations. For example, the National Taxpayer Advocate has proposed imposing withholding on all payments to nonemployees.<sup>4</sup> Proposals that increase withholding could generally be expected to have additional positive impact on both income and employment taxes.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by \$6.4 billion.<sup>5</sup>

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<sup>4</sup> National Taxpayer Advocate, *2004 Annual Report to Congress*, Publication 2104 (Rev. 12-2004), at 484. The proposal is discussed in detail in National Taxpayer Advocate, *2003 Annual Report to Congress*, Publication 2104 (Rev. 12-2003) at 256-269.

<sup>5</sup> At present, the estimate for this proposal does not separately identify the income tax effect from possible FICA or SECA effects and does not incorporate the most recent CBO baseline.

### **3. Provide Consistent FICA Treatment of Salary Reduction Amounts**

Under present law, certain retirement and other employee benefits may be provided through salary reduction contributions by employees. Present law provides inconsistent treatment of such salary reduction amounts for FICA purposes. Contributions made to tax-favored retirement plans by salary reduction, such as contributions to 401(k) plans (including the Federal Thrift Savings Plan), are wages for FICA purposes. However, salary reduction amounts used to provide other benefits are excluded from wages for FICA purposes. The types of nonretirement benefits that may be provided on a salary reduction basis include health coverage (insurance as well as reimbursement of expenses not covered by insurance), dependent care assistance, certain group-term life insurance, and qualified parking, van pooling and transit benefits.

Legislative history indicates that salary reduction retirement contributions are included in the FICA tax base in order to avoid undermining that base and making the Social Security system partially elective. This rationale for the FICA treatment of retirement plan contributions made by salary reduction applies equally to salary reduction amounts used to provide other benefits.

The Joint Committee staff report proposes providing consistent treatment of salary reduction amounts for FICA purposes. One effect of the proposal is to provide more consistent FICA treatment of amounts paid by employees to purchase benefits, regardless of whether the benefits are provided through an employer-sponsored plan. For example, under present law, an employee who cannot purchase health insurance through his or her employer must pay FICA tax on his or her salary, including any amounts used to purchase individual health insurance coverage. Under the proposal, similar FICA treatment applies to salary reduction amounts used to purchase health insurance coverage on a salary reduction basis.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by \$42.4 billion, increase off-budget revenues by \$182.9 billion, and increase outlays by \$2.6 billion, for a net increase in revenues of \$222.7 billion overall.

### **4. Conform Calculation of FICA Taxes and SECA Taxes**

The Social Security Act amendments of 1983 were intended to place SECA taxes on the same economic footing as FICA taxes. This involved equalizing the FICA and SECA tax rates for the first time. At the same time, self-employed taxpayers were allowed a deduction from self-employment earnings in recognition of the fact that such earnings include the "employer share" of SECA taxes, whereas FICA tax rates apply to wages exclusive of the employer share of FICA tax. However, due to a mathematical inconsistency in the calculation of the deduction for SECA purposes, self-employment income is taxed more favorably than wages. The Joint Committee staff proposal modifies the formula for calculating the deduction from self-employment earnings to make SECA taxes economically equivalent to FICA taxes. Under the proposal, the dollar amount of the deduction from self-employment earnings is equal to one-half of SECA taxes owed.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by \$3 billion, increase off-budget revenues by \$1.6 billion, and increase outlays by less than \$50 million, for a net increase in revenues of \$4.6 billion overall.

#### **5. Modify FICA Tax Exception for Students**

Under present law, FICA taxes do not apply to services performed by a student who is enrolled and regularly attending classes at a school, college, or university. Legislative history provides that this exception (referred to as the “student exception”) is intended to apply to situations in which the employment is part-time or intermittent and the total amount of earnings is only nominal, the payment of tax is inconsequential and a nuisance, and the related benefit rights are also inconsequential. However, the student exception has been viewed by certain taxpayers as applying more broadly to include situations that are similar to full-time employment.

The scope of the student exception has been the subject of uncertainty in recent years, particularly with respect to its application to medical residents. In two cases, courts have held that the student exception applies to medical residents performing services at a hospital or other medical facility, whereas another court has held that medical residents are not students for purposes of the exception. Uncertainty as to the proper scope of the student exception results in part from a lack of clear standards for applying the exception.

The IRS issued final regulations in December 2004 relating to the terms “school, college or university” and “student” for purposes of the student exception. Although these regulations help to clarify the scope of the student exception, clear statutory standards would make the exception more administrable. The Joint Committee staff report proposes codifying the IRS regulations that clarify the scope of the present-law student exception. In addition, the report proposes amending the student exception so that it does not apply to individuals whose earnings subject to the exception exceed an annual dollar limit. The original intent of the exception can be implemented more effectively through such a dollar limit.

Under the proposal, the student exception applies to an individual for a year only if the individual’s earnings from the school, college, or university are less than the amount needed to receive a quarter of FICA coverage for the year (\$920 for 2005). Thus, if an individual’s earnings exceed the limit, the individual’s earnings are subject to FICA, regardless of whether the individual otherwise meets the requirements for the student exception. If the limit is exceeded, all of the individual’s earnings are subject to FICA, including earnings up to the limit, thus enabling the individual to receive at least one quarter of coverage for the year.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by \$0.5 billion, increase off-budget revenues by \$3.0 billion, and increase outlays by less than \$50 million, for a net increase in revenues of \$3.5 billion overall.

#### **6. Apply Employment Taxes to Sales Incentive Payments Made by Manufacturers**

Under current IRS guidance, commissions or other sales incentive payments paid by a manufacturer or distributor to sales people employed by a dealer are includible in gross income, but are not subject to FICA or SECA taxes. The basis for this position with respect to FICA

taxes is that the sales incentive payments are not wages because the sales people are not employees of the manufacturer or distributor.<sup>6</sup> Further, because the sales people are employees of a dealer, they are not self-employed and therefore not subject to SECA taxes. In contrast, in other circumstances, under present law, amounts received for services performed by an employee from a person other than the employer are generally treated as wages to the same extent as amounts received from the employer. Although services performed by sales people who are the employees of a dealer benefit the manufacturers and distributors of the products sold, treating sales incentive payments as compensation for services for the manufacturer or distributor creates an artificial standard that causes inconsistent employment tax results. In effect, by structuring compensation as payments from a manufacturer or distributor, the parties can determine among themselves to what extent compensation will be subject to employment taxes. This undermines the employment tax base. Sales incentive payments are compensation for services and, therefore, should be subject to either FICA or SECA taxes.

The Joint Committee staff report proposes that sales incentives payments made by manufacturers or distributors to sales people employed by dealers are wages for FICA tax purposes, regardless of whether an employment relationship exists between the sales people and the manufacturers or distributors.<sup>7</sup>

Over the period 2006-2015, this option is estimated to increase on-budget revenues by \$0.1 billion, increase off-budget revenues by \$0.4 billion, and increase outlays by less than \$50 million, for a net increase in revenues of \$0.5 billion overall.

#### **7. Extend Medicare Payroll Tax to All State and Local Government Employees**

Most workers pay HI taxes during their entire working lives. However, State and local government workers are not covered by Medicare or subject to the HI tax if they were hired before March 31, 1986, and they are not covered by a voluntary agreement and are covered by a retirement plan. Even though not subject to the HI tax with respect to such employment, many State and local government workers receive the same Medicare coverage as other workers, either through other employment or spousal coverage.

The Joint Committee staff report proposes extending Medicare coverage on a mandatory basis to all employees of State and local governments, without regard to their dates of hire or participation in a retirement system. Such employees and their employers would become liable for the HI tax and the employees would earn credit toward Medicare eligibility based on their covered earnings. Expanding the HI tax to all State and local government workers would increase the equity of the payroll tax system. Extending the hospital insurance tax to all State and local employees places such employees in a comparable position to most other workers.

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<sup>6</sup> Under current IRS guidance, sales incentive payments are also not subject to income tax withholding.

<sup>7</sup> The proposal also subjects such payments to income tax withholding.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by \$4.9 billion and increase outlays by less than \$50 million, for a net increase in revenues of \$4.9 billion overall.

#### **8. Additional Proposals**

The Joint Committee staff report contains other proposals that, while not specifically targeted at employment taxes, may have an effect on such taxes. For example, as part of a proposal to provide consistent treatment for all taxpayers for dependent care expenses, the report includes an option to repeal the exclusion for employer-provided dependent care assistance. This proposal would have an effect on both income and employment taxes. Similarly, as part of a proposal to provide more consistent treatment for education expenses, the report includes an option to repeal the exclusion for tuition reductions. This proposal would likewise have an effect on both income and employment taxes. Other proposals that would have the effect of modifying exclusions or the calculation of net income from self employment could also have effects on employment taxes.

Proposals beyond those contained in the Joint Committee staff report may also merit exploration. For example, as mentioned previously, the National Taxpayer Advocate has a proposal that would extend withholding to all payments to service providers subject to information reporting. Such a proposal raises issues in addition to those raised by the Joint Committee staff option. If adopted, it could also be expected to further increase employment tax revenues.

As another example, the Joint Committee staff option that would impose FICA taxes on all benefits provided on a salary reduction basis could be expanded. One possible option would be to provide that nonretirement employee benefits are subject to FICA taxes. Such a proposal would provide consistent FICA tax treatment with respect to such benefits. A variety of issues would need to be addressed under such a proposal that do not arise under the published Joint Committee staff option. For example, valuation issues do not arise under the published option because the amount of salary reduction is known. However, valuation issues may arise with respect to benefits that are not provided on a salary reduction basis. Other policy issues may also arise. Depending on how broadly this option is designed, it could be expected to increase significantly FICA tax revenues and may also increase Social Security benefits for some individuals.

#### **Proposals Relating to Employment Tax Rates and the Employment Tax Cap**

In addition to, or in conjunction with, expanding the employment tax base, the solvency of the Social Security system could be addressed by modifying employment tax rates or the employment tax cap. I present here some possible options for discussion purposes.<sup>8</sup>

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<sup>8</sup> The very preliminary estimates presented with respect to these options do not include possible increases in outlays due to increases in benefits.

### 1. Remove Employment Tax Cap

For the period 2006-2015, removing the cap on wages subject to the OASDI portion of FICA and SECA taxes, and maintaining the present-law rate, is estimated to increase off-budget revenues by \$1,477 billion and decrease on-budget revenues by \$233 billion, for a net increase in revenues of \$1,245 billion overall.

An alternative would be to apply a lower rate to wages above the present-law tax cap. For example, a tax could be imposed at a rate of 2.9 percent<sup>9</sup> on wages above the present-law tax cap. The rate of tax on wages below the tax cap would remain unchanged. The 2.9 percent would be in addition to present-law HI taxes of 2.9 percent. This proposal is estimated to increase off-budget revenues by \$352 billion and decrease on-budget revenues by \$55 billion, for a net increase in revenues of \$297 overall for the period 2006-2015.

Removing the cap would help increase the solvency of Social Security and would increase the degree of progressivity of the Social Security tax structure. It would raise marginal tax rates on all earners currently above the cap. Removal of the cap would require a decision as to whether benefits should increase for such taxpayers. Increasing benefits for the highest wage earning taxpayers may not be desirable given Social Security's current long-run imbalances. On the other hand, to raise the taxes on the highest earners without commensurate benefit increases would further break the link between earnings and Social Security benefits. A similar proposal with a lower tax rate for the earnings above the current cap would present similar issues but would raise less revenue.

### 2. Remove Employment Tax Cap, and Lower Employment Tax Rate

An alternative proposal is to remove the cap on wages subject to the OASDI portion of FICA and SECA taxes, but lower the rate on wages so that the proposal is close to revenue neutral. Such a proposal would not increase Social Security revenues, but is provided as a means of illustrating the trade offs between the rate and the base for the tax. If the tax cap were removed, it is estimated that the rate on the employee portion of OASDI taxes could be reduced by 1.8 percent, for a resulting rate of 4.4 percent.<sup>10</sup> This proposal would result in a decrease in revenues of \$2.2 billion over the period 2006-2015.

Removal of the cap while lowering the rate would have effects similar to the first option above with respect to progressivity of the Social Security, though to a greater degree. Taxes would rise for high earners and fall for low earners, increasing the degree of progressivity of the Social Security tax structure. These changes would increase labor supply incentives for workers currently below the cap, while decreasing such incentives for those above the current cap. Similar to the first option (and raising similar issues), a decision would have to be made as to whether higher wage taxpayers would also receive higher benefits due to the expanded wage

<sup>9</sup> It is assumed that one-half of the rate increase is imposed on employers and one-half on employees.

<sup>10</sup> It is assumed that the rate on the employer portion of OASDI taxes remains the same as under present law.

base. Also, just as increasing benefits for the highest wage earning taxpayers may not be desirable given Social Security's current imbalances, this option's lowering of the rate of tax might be similarly viewed.

### **3. Raise the Employment Tax Cap to Apply to 90 Percent of Covered Wages**

Raising the employment tax cap so that it applies to 90 percent of covered wages in 2006 and thereafter would result in a tax cap of \$170,000 for 2006 (from a projected cap of \$93,000 under present law). For the period 2006-2015, this proposal would increase off-budget revenues by \$664 billion and decrease on-budget revenues by \$86 billion, for an increase of \$578 billion overall.

Raising the cap to cover 90 percent of wages would help increase the solvency of Social Security. Applying OASDI taxes to 90 percent of covered wages was expressed as a goal of Congress in the past when issues of Social Security solvency were being addressed.<sup>11</sup> Over time, indexation has not maintained this level because of greater earnings growth of individuals with wages over the tax cap.

Raising the cap would place the greatest relative burdens on those with earnings near the new cap, and cause marginal tax rates to rise sharply for those with earnings between the new and the old cap. For this reason, this change could be viewed as regressive as the "lower wage" segment of those with earnings above the current tax cap would experience the greatest percentage increase in taxes. The same issues as in the options above arise as to whether benefits would increase for the affected taxpayers.

### **4. Raise Employment Tax Rate**

The rate of OASDI tax could be increased. For example, increasing the OASDI tax rate by one-percentage point (one-half of which would be imposed on employers and one-half on employees) would increase off-budget receipts by \$579 billion and decrease on-budget receipts by \$61 billion, for a net increase in revenues of \$519 billion overall for the period 2006-2015.

Raising rates without altering the cap would help increase the solvency of Social Security. Marginal tax rates would increase for taxpayers below the cap, but remain unchanged for those above the cap. Regardless of the rate chosen, this approach distributes the increased tax in direct proportion to a taxpayer's current tax—that is, it maintains the current degree of progressivity of the Social Security tax and benefit structure. Since the tax base is not changed, this approach does not automatically raise issues related to the benefit side of Social Security that arise when the tax base is altered.

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<sup>11</sup> See H.R. Rep. No. 95-702(Part I), 95<sup>th</sup> Cong., 1<sup>st</sup> sess. and H.R. Conf. Rep. No. 95-839, 95<sup>th</sup> Cong., 1<sup>st</sup> sess.

### 5. Additional Options

Congress could increase the solvency of Social Security by seeking revenues outside of the traditional payroll tax approach. Clearly there would be many ways to do this, spanning all of the Federal government's revenue sources. But all revenue raising measures would necessarily involve base broadening or tax rate increases.

Seeking revenues outside of the payroll structure would represent a major change to Social Security financing. Depending on how the revenue was raised, the Social Security system could become either more progressive or less progressive. To the extent Social Security is funded from general Federal revenues, some might view the change as further breaking the link between earnings and Social Security benefits.

\* \* \*

The Joint Committee staff looks forward to working with the Committee on the proposals contained in the report, as well as in developing additional proposals of interest to the Committee.

Thank you for the opportunity to testify.

109TH CONGRESS, 1ST SESSION

HOUSE	SENATE
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## Congress of the United States

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DEPUTY CHIEF OF STAFF

Honorable Charles Grassley  
United States Senate  
SH-135  
Washington, DC 20510

JUN 20 2005

Dear Senator Grassley:

This letter responds to questions submitted for the record by you and Senator Rockefeller in response to my testimony before the Senate Committee on Finance on May 25, 2005, at the hearing on "Social Security: Achieving Sustainable Solvency."

As you requested, the attached table provides year by year revenue estimates for the employment tax options included in the recent Joint Committee on Taxation staff report on "*Options to Improve Tax Compliance and Reform Tax Expenditures*" that I discussed in my testimony. These estimates differ from those included in that report, in part, because they reflect our most recent baseline. In addition to providing the total revenue effect of each proposal, we have also provided the on-budget effects, which consist of income taxes and the Medicare Hospital Insurance ("HI") component of FICA and SECA, and the off-budget effects, which consist of the old age, survivor and disability insurance ("OASDI") component of FICA and SECA. The off-budget receipts are dedicated to the Social Security Trust Fund. In addition, the table shows preliminary estimates of the outlay effects associated with each proposal as provided to us by the Congressional Budget Office ("CBO"). Please note that these proposals were estimated as stand-alone provisions and therefore do not include any interaction effects. Also, there are other provisions included in our report that could have off-budget effects, such as the proposal to impose withholding on certain payments made by government entities and the proposal to provide uniform treatment for dependent care benefits. At present, we have not updated the revenue estimates for these proposals, as included in our report, to incorporate the most recent CBO baseline and to separate the on-budget effects from the off-budget effects.

We have forwarded Senator Rockefeller's question regarding the effects of these proposals on Social Security's long-term shortfall to the CBO. In addition, Senator Rockefeller also asked how much of the cost of private accounts carved out of OASDI revenues could be covered by the employment tax proposals included in the recent Joint Committee on Taxation staff report. The cost of such a proposal would depend on a variety of factors, including whether the accounts were mandatory or voluntary, and if voluntary, on the amount of participation, which would depend on the particulars of the proposal. However, for purposes of comparison, we estimate that the proposal to provide consistent FICA treatment of salary reduction amounts would increase OASDI revenues by about 2.5 percent (\$183 billion) of projected baseline

Congress of the United States  
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Honorable Charles Grassley  
United States Senate

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OASDI revenues (\$7,591 billion) over the 2006-2015 budget window (as projected by CBO in their 2005 economic and revenue forecast).

I hope this information is helpful to you. Please let me know if we may be of further assistance in this matter.

Sincerely,



George K. Yin

cc: Susan Jenkins

Enclosure: Table #05-2 101

- Senator Grassley -  
ESTIMATED REVENUE EFFECTS OF EMPLOYMENT TAX GAP OPTIONS

Fiscal Years 2006 - 2015

[Billions of Dollars]

Provision	Effective	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
1. Provide consistent FICA treatment of salary reduction amounts:													
a. On-budget.....	wispa 12/31/05	1.6	2.5	3.1	3.9	4.3	4.7	5.0	5.4	5.8	6.2	15.4	42.4
b. Off-budget.....	wispa 12/31/05	9.7	14.4	15.4	16.6	17.6	18.8	20.2	21.7	23.3	25.0	73.7	182.9
c. Outlay effects [1].....	wispa 12/31/05	--	[2]	-0.1	-0.1	-0.1	-0.2	-0.3	-0.4	-0.6	-0.9	-0.3	-2.6
Total .....		11.2	16.9	18.5	20.4	21.8	23.3	25.0	26.7	28.5	30.4	88.8	222.7
2. Conform calculation of FICA taxes and SECA taxes:													
a. On-budget.....	tyba 12/31/05	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4	1.3	3.0
b. Off-budget.....	tyba 12/31/05	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.7	1.6
c. Outlay effects [1].....	tyba 12/31/05	--	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
Total .....		0.3	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.6	2.0	4.6
3. Extend Medicare payroll tax to all State and local government employees:													
a. On-budget.....	wispa 12/31/05	0.7	0.8	0.8	0.7	0.6	0.4	0.3	0.3	0.2	0.1	3.6	4.9
b. Off-budget.....	wispa 12/31/05	--	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
c. Outlay effects [1].....	wispa 12/31/05	0.7	0.8	0.8	0.7	0.6	0.4	0.3	0.3	0.2	0.1	3.6	4.9
Total .....		1.4	1.6	1.6	1.4	1.2	0.8	0.6	0.6	0.4	0.2	7.2	9.8
4. Modify FICA tax exception for students:													
a. On-budget.....	[3]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	0.1	0.1	0.1	0.2	0.5
b. Off-budget.....	[3]	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4	1.4	3.0
c. Outlay effects [1].....	[3]	--	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
Total .....		0.2	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	1.6	3.5
5. Apply employment taxes to sales incentive payments made by manufacturers:													
a. On-budget.....	sip/spa 12/31/05	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	0.1
b. Off-budget.....	sip/spa 12/31/05	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	0.2
c. Outlay effects [1].....	sip/spa 12/31/05	--	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
Total .....		[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	0.2

Provision	Effective	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
6. Modify determination of amounts subject to employment or self-employment tax for partners and S corporation shareholders:													
a. On-budget.....	[5]	2.2	3.0	3.3	3.5	3.7	3.8	3.9	4.1	4.3	4.5	15.6	36.3
b. Off-budget.....	[5]	1.9	2.6	2.6	2.7	2.9	2.9	3.0	3.1	3.2	3.2	12.7	28.2
c. Outlay effects [1].....	[5]	--	[2]	[2]	[2]	[2]	[2]	-0.1	-0.1	-0.1	-0.1	-0.1	-0.5
Total .....		4.1	5.6	5.8	6.2	6.5	6.7	6.9	7.2	7.4	7.6	28.3	64.0

**Joint Committee on Taxation**

NOTE: Details may not add to totals due to rounding. Date of enactment is assumed to be October 1, 2005.

**Legend for "Effective" column:**

- sjfspa = sales incentive payments for services performed after taxable years beginning after
- wfspa = wages for services performed after

[1] The outlay effects are provided by the Congressional Budget Office and should be viewed as preliminary and subject to change. These outlay effects represent increases in spending.  
 [2] Increase in outlays of less than \$50 million.  
 [3] The proposal relating to codification of the regulations is effective on the date of enactment. The proposal relating to the application of an annual dollar limit on the student exception is effective with respect to wages for services performed after December 31, 2005.  
 [4] Gain of less than \$50 million.  
 [5] Effective for taxable years of partners or S corporation shareholders beginning after December 31, 2005.

## COMMUNICATIONS

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### STATEMENT FOR THE RECORD

United States Senate Committee on Finance

Hearing Title: "Social Security: Achieving Sustainable Solvency"

Hearing Date: May 25, 2005

Submitted by David J. Clark, CPA

Chairman Grassley, Senator Baucus and Members of the Committee, I thank you for the opportunity to provide my Statement for the Record.

I am a practicing Certified Public Accountant (CPA) in California. I have significant "hands-on" experience with many of the issues raised in this hearing. The opinions expressed herein are mine and should not be attributed to any of the organizations with which I am associated.

As you know, George K. Yin, Chief of Staff of the Joint Committee on Taxation (JCT), presented testimony at this hearing. Part of his testimony referred to a report prepared by the staff of the JCT titled "*Options to Improve Tax Compliance and Reform Tax Expenditures*" (JCS-02-05), January 27, 2005.

Page 98 of the above report in the first paragraph under Reasons for Change states: "The uncertainty in treatment creates an opportunity for abuse by taxpayers willing to make the argument that they are not subject to any employment tax (FICA or self-employment), even though this argument is contrary to the spirit and intent of the employment tax rules."

This statement is misleading. According to committee reports, section 1402(a)(13) was added in 1977 to prevent passive investors who do not perform services from obtaining social security coverage. (House Committee Report on Pub L No. 95-216, 91 Stat 1509 [1977].)

The 1977 law was intended to limit benefits. Arguably similarly-situated taxpayers (i.e., LLC members) should also have been denied benefits. Therefore, at the time, it would have been an "abuse" to try to obtain coverage for similarly-situated taxpayers.

Times have changed. We are now in a "raise revenue" rather than "limit benefit" world. It is now political to argue that it is an "abuse" to "avoid or reduce employment tax."

I believe the “Reasons for Change” in the JCT report should be factually accurate rather than politically colored. The “opportunity for abuse” and “contrary to the spirit” language should be removed or an explanation to the effect that “we need money now” added to explain the shift in emphasis that has occurred over the years. Either that, or make clear the consistent position that benefits are not available to similarly situated taxpayers.

There are many taxpayers and practitioners who want to do the “right thing,” whatever that is. There is no guidance in this area and there has not been for a long time. The JCT report (and any forthcoming legislation) should provide that guidance rather than place blame.

With respect to the last paragraph under Reasons for Change, there are nontax reasons that dictate “choice-of-business form” decisions. A “desire to avoid or reduce employment tax” is not the sole motivation to choose one form over another. I believe this statement is overbroad.

Finally, it occurs to me that much of the perceived benefit of expanding the revenue base in the above fashion might be eroded if many of the affected taxpayers see fit to elect to contribute their new found “earned income” into retirement plans.

Respectfully submitted,

David J. Clark

WHITHER SOCIAL SECURITY?

Donald S. Grubbs, Jr., J.D., F.S.A.

June 21, 2005

INTRODUCTION

When I chose "Whither Social Security?" as a title for this talk, I had some trepidation that if I didn't clearly enunciate the first H in whither, some might mistake me as one who expects Social Security to wither away. I am not.

BENEFITS

Since much of the discussion involves changes in Social Security's benefits, I'm going to start with a quick summary of the benefits we have now. I'll only mention the major provisions as they apply to most people; there are lots of exceptions.

Who Is Covered

First, who is covered? Almost all employees and self-employed persons in America are covered. There are two principal exceptions. First, federal government employees hired before 1984 are generally excluded because they are covered under a separate program which is quite generous. Second, state and local governments are permitted to exclude their employees. Most of these state and local government employees are covered under government employee plans which are equivalent to Social Security plus a supplemental pension plan. But if a state government employee leaves employment before becoming vested in any benefit, he may get nothing from the state's plan and may get a smaller Social Security benefit than if he had been covered under Social Security during those years.

Homemakers who are not paid compensation are not covered under Social Security.

Kind and Amount of Benefits

The 1935 Social Security Act provided only old age benefits. Survivor benefits were added in 1939 and disability benefits were added in 1956. All of these benefits have been modified and expanded over the years.

When Social Security was being established, there were arguments over whether benefits should be based on individual equity or social adequacy. Individual equity argues for each worker receiving the benefits that can be provided by his own contributions. Social adequacy argues for each worker getting benefits that will meet his needs. Some think of social adequacy in terms of the amount that every person needs to avoid poverty. Others think of social adequacy in terms of being able to maintain a standard of living similar to what we had before retirement.

The present Social Security system is a compromise between these two principles of individual equity and social adequacy. This same basic tension underlies much of today's disputes.

What kind of a retirement benefit do people need when they retire? They need an income that is initially adequate, that continues for life, and that keeps pace with inflation.

How much are Social Security's benefits? The median worker earned about \$35,000 last year. If this median worker retires at age 65 this year, he will receive about \$15,000, or about 42% of his final pay. By

itself that's not what most of us would consider an adequate income, but it is well above the poverty level and will keep him from starving. Many retirees also have an employee pension or personal savings to supplement Social Security, but many other retirees depend solely on Social Security.

This replacement of about 42% of the final rate of pay for the median worker retiring at age 65 remained fairly stable for many years. But this replacement percentage is gradually decreasing for those born after 1937 until it will reach only 36% for those born in 1960 and later. It would be expected to remain at about 36% for those born after 1960 if the benefit provisions are not changed. This replacement percentage is higher for those earning less than the median worker and lower for higher paid workers.

Workers can retire at age 62 or any later age. The later that benefits begin, the larger the monthly benefit, except that there is no such increase after age 70. There is no advantage in delaying the start of benefits after age 70 even if you are still working. The majority of workers actually start receiving benefits at age 62. Benefits are reduced or eliminated if you work and earn over \$12,000 annually before age 65 1/2.

If, instead of retiring at age 65, the median worker retires this year at age 62, as most workers do, his Social Security benefit will not be 42% of his final pay, but only about 33%. On the other hand, if he waits until age 70 to start his benefit, it will be larger than 42%. The reason behind this difference by age is that if benefits start at an earlier age, they will generally be paid longer, so lower benefits on earlier retirement offset the cost of paying them longer.

You may have heard that the Social Security retirement age is increasing. This is often misunderstood. The age at which benefits can begin –age 62 – is not changing at all. In 1983 Congress enacted a gradual increase in the age used to calculate the adjustment in the benefit amount for earlier retirement or deferred retirement. It doesn't affect when people actually retire. The result is that those who retire at age 62 after this phase-in will get a smaller benefit than if there had been no such change. Similarly, benefits will be smaller for those retiring at age 65 and for those retiring at age 70. This is not really a change in retirement age; it's a reduction in benefits.

A worker's spouse is generally entitled to a monthly benefit equal to 50% of the worker's benefit if this is larger than the benefit based on the spouse's own wage record. This 50% is adjusted if the two are not the same age. This spouse's benefit used to apply to many women who worked at home without compensation, but now most women have done substantial work covered by Social Security and earn a benefit based on their own earnings that is larger than 50% of her husband's benefit. Thus in recent years fewer women have been receiving benefits based on their husband's earnings.

After age 62 benefits are adjusted annually to keep pace with inflation.

When a covered worker dies, monthly survivor benefits are paid to any dependent children. If the deceased worker is survived by a spouse age 60 or older, the spouse may be entitled to monthly income for life. In addition a \$255 lump sum death benefit may be payable to the worker's widow or widower.

Disability pensions are payable to workers who have been covered at least five years and who become permanently and totally disabled.

Last year 157 million workers paid payroll taxes under Social Security and 48 million beneficiaries were receiving benefits. About two thirds of these beneficiaries were receiving old-age retirement benefits and the other one third were about equally divided between those receiving survivor benefits and those receiving disability benefits.

**FUNDING**

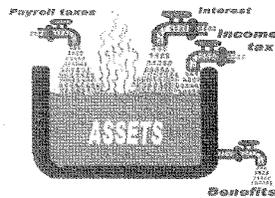
Some say that Social Security is funded on a pay-as-you-go basis. This is not correct. Pay-as-you-go funding looks like this:



Under pay-as-you-go funding, input to pay the benefits is made when the benefits are paid. Input equals output every year. There is no accumulation of assets and no fund. This can work satisfactorily if the employer or some other source can be depended on to pay the costs indefinitely. Pension plans covering federal employees and many state employee pensions have operated on a pay-as-you-go basis and, since these entities are generally strong, this has worked, although growing costs have become burdensome for some of them.

Prior to 1974 a few private-sector employers operated pension plans on a pay-as-you-go basis. Horn & Hardart's had such a plan, but when the company went bankrupt, pensions stopped for 400 retired employees because there were no assets to continue them or to provide pensions for any of the active workers who had worked many years and expected to receive a pension when they retired. I and others worked to enact a law to require all private-sector employers who promise pensions to contribute to a pension fund in order to provide greater assurance that the promised pensions will ultimately be paid. Under advance funding contributions are generally accumulated before a worker retires so that there will be enough assets to pay the benefits after retirement. When this law was on the verge of enactment in 1974, I moved to Washington to help implement it.

Social Security's funding looks like this:



This tank represents the Trust Fund. Actually Social Security has two Trust Funds, one for the old-age and survivor benefits and one for the disability benefits. But as a practical matter Congress has often

treated these two as a single Trust; it has diverted contributions from one to the other and made loans between these two Trusts whenever needed. I'll speak of it as a single Trust Fund.

Benefits are shown coming out on the right -- about \$500 billion of them last year.

In addition to the benefits, the fund pays administrative expenses, shown here as evaporation from the tank. These are less than one percent of the benefit payments -- remarkably low. I have consulted for many employee pension plans, and I never saw one with expenses anywhere near this low.

The water in the tank represents the assets of the Trust. The assets are now about \$1.7 trillion, enough to keep paying the benefits another three years if contributions stopped entirely. This is very different from the advance funding requirements for private pension plans, which generally accumulate assets sufficient to continue the payments to those already retired for life and also to have substantial reserves building up to provide pensions for those not yet retired. For Social Security this is not a problem, because it was always intended that each year's benefits would be provided primarily by the payroll taxes paid that year, like a pay-as-you-go plan. But a small Trust Fund was planned, with a goal of building up a buffer to provide some flexibility to deal with fluctuations in income and outgo. Thus this is neither an advance-funded plan nor a pay-as-you-go plan, but can be better described as a modified pay-as-you-go program.

The primary source of Trust income is wage taxes. Employees and employers each pay 6.2% of the first \$90,000 of pay each year. This \$90,000 cap on taxable wages is adjusted annually to reflect increases in average compensation. Self-employed people pay 12.4%, equal to the employer tax plus the employee tax.

In addition the Trust Fund gets input from two other sources. It receives interest from the U.S. Government bonds that the Trust is invested in. Last year this interest amounted to about one seventh of the total income of the Trust. The Trust assets are expected to decrease in future years, so the interest earnings will be a smaller part of the income in the future.

The third source of input is income taxes. Lower income individuals receiving Social Security benefits pay no income tax on their benefits, but most recipients must include a percentage of their Social Security benefit in taxable income. Most of the income taxes based on Social Security benefits are paid into the Trust.

In 1984 the Trust also received a transfer from general tax revenues, but that was the only time that general revenues were used as input.

Altogether last year the input was \$156 billion more than the outgo, increasing the Trust balance to \$1.7 trillion.

## PROJECTIONS

### The Basis of Projections

The future income and outgo of the Trust Fund depend on many factors, including birth rates, death rates, disablement and recovery rates, immigration and emigration, marriage and divorce, the ages at which people retire, inflation, wage increases, productivity gains, and many other factors.

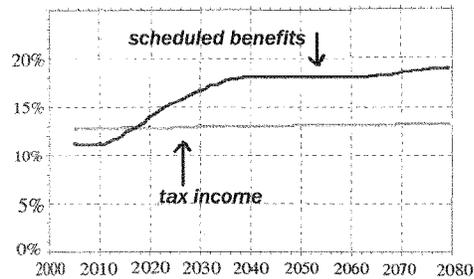
Social Security's actuaries carefully study past experience and trends and other things that they think might affect future experience. They select what they think are the most likely assumption for each factor

and call these the “intermediate assumptions”. They make 75-year projections based upon these intermediate assumptions, assuming no future change will be made in the program.

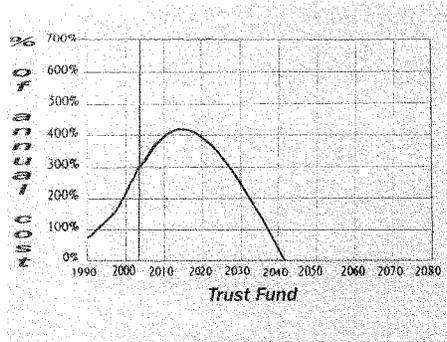
I have known many of Social Security’s past and present actuaries. In the past I spent hours reviewing their work and discussing it with them. Since retirement I have continued to read their reports. I have the very highest respect for their ability and their integrity. In my opinion the intermediate assumptions are reasonable. While I might have selected some assumptions that were slightly different than theirs, they would not be far different and the projected results would not be far different.

#### Projection Results under the Intermediate Assumptions

In a nutshell, here is the projection over the next 75 years of the income and outgo of the Trust as a percentage of the taxable earnings, based on these intermediate assumptions and the presently scheduled level of taxes and benefits:



Last year the income from wage taxes and income taxes was about 13% of taxable wages. This percentage is projected to remain about 13% over the next 75 years. The payments from the Trust last year were only about 11% of taxable wages, which was less than the income rate. But these payments are projected to increase, and to exceed the tax income beginning in 2017. Beginning in 2017, to fill this projected shortfall the Trust Fund would sell some of its bonds. Some say that this would force the government to raise taxes in order to pay off the bonds, but this is not correct. The government redeems maturing bonds every year. It simply sells new bonds to get the cash to replace the maturing bonds, and it could continue to do this after 2017, as it did in those prior years in which benefit payments exceeded Trust income. The payments are projected to reach 19% of taxable wages by the end of the 75-year period, far more than the income rate. What would this do to the Trust Fund?

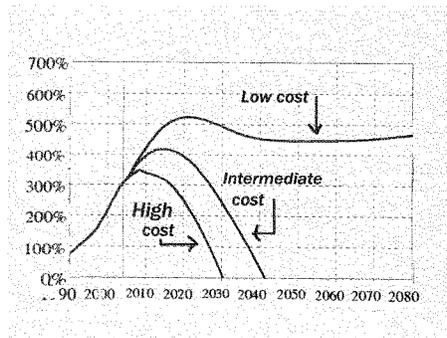


The projection indicates that the Trust Fund balance, currently equal to about three years of benefit payments, would continue to increase for a few years and then begin to fall. It would be exhausted in 2041. The projections indicate that in 2041 the tax income would be sufficient to pay only 74% of the benefits. If the income were not increased, this would require reducing benefits by 26% in 2041, and by even more by the end of the 75-year period.

Uncertainty and Alternative Projections

Is this what Social Security’s actuaries are predicting? By no means! This is only their projection based on the intermediate assumptions. In the recent 217-page report of the trustees, no sentence is more important than this one: “Any projection of the future is, of course, uncertain.” Any one who projects what inflation rates, wage increases, immigration rates and other key factors will be over the next 75 years realizes how uncertain these assumptions are.

Recognizing the uncertainty of the intermediate assumptions, Social Security has always made two other projections, called “high cost” and “low cost” assumptions. Here are the results:



Under the high cost assumptions the problem would be worse. The Trust Fund would be exhausted in 2030 instead of 2041, and if the income were not increased, this would require even greater benefit cuts than under the intermediate assumptions.

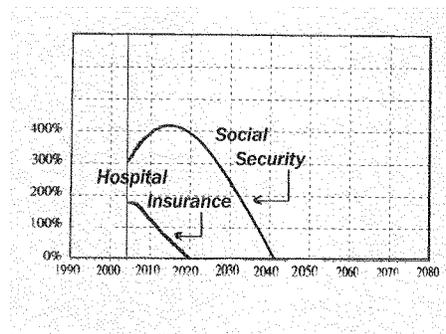
But under the low cost assumptions the Trust Fund would never be exhausted during the 75 years. No change at all in the program would be needed.

It is possible that the actual experience will even fall outside of this wide range. But I agree with the trustees' report that outcomes better than the low cost projection or worse than the high cost projection "have a very low probability of occurring."

But what will the future results actually be? No one really knows. Almost all of those experts who have studied the matter concur that it is highly likely that there will be some deficit in the future, but that it may be substantially more or less than under the intermediate projections. Unfortunately many of those who support or oppose the President's proposals speak as if the intermediate projections represent the future.

#### The Hospital Insurance Trust

I have talked about the funding of the Social Security Trust. Medicare's Hospital Insurance Trust is also financed by a payroll tax, and it has similar problems. Based upon the intermediate projections, here is how the two programs compare:



As we saw before, the Social Security Trust Fund is now equal to about three times the annual benefits. It would rise for a few more years and then fall and be exhausted in 2041, 36 years from now. Medicare's Hospital Insurance Trust is now only 150 % of its annual benefit payments; this 150% would fall every year and the Hospital Insurance Trust would be exhausted in 2020, only 15 years from now.

The projected shortfall of the Social Security Trust in dollars is large, but the shortfall of Medicare's Hospital Insurance Trust is far larger. In addition to these problems of the Hospital Insurance Trust, other parts of the Medicare program are projected to have enormous cost increases in the coming years. Total Medicare costs as a percentage of gross domestic product are projected to quintuple during the next 75 years.

Is it logical to attempt to solve Social Security's problems before considering the problems of Medicare's Hospital Insurance? Why do some say that it is imperative to solve Social Security's problems right away, while they propose nothing for Medicare's problems?

#### SOLUTIONS

What are the possible solutions for Social Security? All possible solutions to the projected imbalance require either increasing the income of the Trust or decreasing the benefits.

The President advocates decreases in benefits.

#### Decreasing Benefits

Several alternative ways for decreasing benefits have been suggested. However, everyone agrees that no change should reduce benefits for those already over age 55.

One approach to decreasing the outgo is to change the method of calculating benefits, which are based on average of the wages you earned during most of your working years. A cup of coffee no longer costs five cents, but fortunately wage rates have risen about one percent more than inflation annually. This has enabled the average American to have a rising standard of living over the decades. More Americans have cars and telephones than when we were young. No one has an ice box; we all have electric refrigerators and these are better than those available when we were young. And we have many things that were not available at all in earlier years – television, computers, and heart transplants. When Social Security calculated the average of my earnings to determine my benefit, the enormous annual salary of \$3,800 that I earned in 1954 was first adjusted to reflect the increase in average earnings between 1954 and the year I turned age 62. After my earnings for each year were adjusted, an average of these adjusted earnings for my 35 highest years was calculated, and my benefit was based on this average of my adjusted earnings.

This adjustment enables benefits to reflect wage levels and the standard of living around the time of retirement. It is this adjustment that has kept Social Security benefits fairly stable over the years as a percent of the final earnings rate for most workers.

Some have proposed adjusting each year's earnings by the cost-of-living increase rather than the average wage increase. Because the cost-of-living increases are generally smaller than wage increases, this proposal would result in much smaller benefits. This new method would only apply to future years, so the reduction would be phased in gradually. In effect it would make benefits reflect a standard of living of earlier years rather than the standard of living at retirement time.

President Bush has commended a proposal developed by Robert Pozen, which would adopt this cut-back for higher-paid workers, keep the present system for the lower-paid 30% of workers, and adopt an in-between approach for middle-income workers. Based on the intermediate assumptions this proposal would ultimately reduce benefits for higher paid workers by about half, and would reduce benefits for the median worker by 28%. Some argue that this is not a reduction, only a smaller increase. Clearly it is a major reduction from the benefits payable under current provisions. Benefits would decrease as a percentage of pay rates near retirement, causing the individual's standard of living to plummet the day he retires. Based on the intermediate assumptions it is estimated that this cutback would eliminate 70% of the projected shortfall in funding.

Another possible approach to reducing benefits that people talk about is increasing the retirement age. After all, people are living longer and are healthier in their old age. While it would be possible to discuss changing the minimum age of 62 at which workers can retire, no one is talking about this. What they are

talking about is again changing the age from which adjustments for early or late retirement benefits are calculated, which is currently age 65 and 6 months. The majority of workers now actually retire at age 62. The effect of increasing the so-called "retirement age" would not be to change the age at which people could retire, which would remain age 62. Rather it would reduce the amount of benefits for those who retire at age 62, reduce the amount for those who retire at age 65, and reduce the amount for those who retire at age 70 or any other age. It is not really a change in retirement age, but a reduction in benefits disguised as a change in retirement age.

Another approach that has been suggested to reduce benefits is to reduce the inflation adjustments after retirement to only half of the CPI increase. The inflation rate has varied from time to time. The CPI increased an average of 4.5% per year during the 40 years ending in 2003. If it increases at that rate in the future, things will cost twice as much in 16 years and four times as much in 32 years. We need an income that keeps pace with inflation. Benefits that do not keep up with inflation are in fact decreasing benefits in their purchasing power.

There are also other ways one could change the benefit formula to reduce benefits and costs.

Present Social Security benefits are not sufficient to provide what most of us would call an adequate retirement income. But for many this is the only source of income in retirement. To reduce the current benefit levels would be tragic. Benefits should not be reduced if there is any other feasible solution. There is.

#### Increasing Income

The alternative to cutting benefits is to increase the income of the Trust. There are several ways to increase the income. Since Social Security's problems are not immanent, any increase could be phased in gradually.

First, we should increase the \$90,000 cap on earnings subject to the Social Security wage tax. Most workers must pay wage taxes on all of their earnings, but higher paid employees pay no tax on earnings over \$90,000. This \$90,000 cap is indexed to the increase in average wages. In 1983 Congress agreed to the goal of setting the cap at a level to cover 90% of all earnings. But because the compensation of the higher paid has risen faster than compensation of other workers, the \$90,000 cap now covers only 85% of all compensation. Returning to the 90% goal would increase the taxable wage cap from \$90,000 to about \$140,000, and some advocate raising the cap further. I favor gradually eliminating the cap entirely so that higher paid workers would pay Social Security tax on all of their pay like lower paid workers do. This would be like Medicare, which has no cap on the amount of wages subject to the Medicare wage tax. An increase in the cap would increase the Trust's income more than it would increase the benefits paid. It is estimated that raising the cap to \$140,000 would reduce the funding deficit by about a third, and raising it further could eliminate most of the deficit.

Second, we should require that all new employees of state and local governments be covered under Social Security. This would increase both the income and outgo of the Trust, but would make a net reduction in the deficit of the Trust.

Third, we should increase the investment income flowing into the Trust Fund by changing part of the investments from government bonds to corporate bonds and common stocks. I don't know of any corporate pension plan that invests most of its plan assets in low-yielding government bonds.

Another possibility relates to the estate tax. Under current law the federal estate tax is being gradually reduced and will be eliminated entirely in 2010, but this reduction and elimination is temporary and the

tax is scheduled to bounce back into force in 2011. Some Members of Congress propose to permanently eliminate the estate tax. I advocate keeping the estate tax, perhaps with modification, and paying all estate taxes collected into the Social Security Trust. The Social Security Trust needs the money more than affluent heirs.

Another way to increase the Trust's income is to increase the wage tax rate, which is now 6.2%. The rate could be increased by 0.1% per year until the needed level is reached. Since wage levels generally rise about one percent faster than prices, this would still result in real increases in take-home pay for most workers, using only a small part of the productivity gains to strengthen Social Security. This approach currently has no support.

Any temporary deficit could be solved by borrowing from general revenues or other sources.

Finally, the income of the Trust could be increased by a direct transfer from general revenue, as was done in 1984. This, of course, would eventually require either raising taxes or reducing other government expenditures.

Of course the deficit could be solved by some combination of increasing the income and reducing the benefits. This was the compromise approach taken in the last major change in Social Security in 1983.

#### Decreasing Benefits or Increasing Income

While Social Security benefits are sufficient to keep beneficiaries out of poverty, by themselves they do not provide what most of us would call an adequate retirement income. But for many this is their only source of income in retirement. To reduce current benefit levels would be tragic. Benefits should not be reduced if there is any other feasible solution. I have outlined several possible and affordable ways of increasing the income of the Trust. While each of these possible ways to increase the Trust's income has disadvantages, all of them are better than cutting needed benefits.

#### Timing of Changes

Social Security has no crisis. While making adjustments sooner will require less abrupt changes later, there is no ultimate harm in delaying the fix. It is far more important to make right decisions than to make fast decisions.

#### Automatic Adjustments

The amount of change that is needed is very uncertain. If we make changes calculated to exactly eliminate the projected deficit under the intermediate assumptions, in a few years we might discover that the change was either too little or was more than needed. We might again find some one crying, "Social Security is going bankrupt!", again causing citizens to lose confidence in the system.

I recommend that we adopt changes during the next few years that will substantially reduce the projected deficit under the intermediate projection, and that we also adopt an automatic adjustment mechanism that will permanently keep the system in balance. This mechanism could have two parts. First, it would provide that if the Trust is ever exhausted there will be an immediate interest-bearing loan from general revenues sufficient to make benefit payments as they are due; this would solve the immediate problem. Second, it would provide for an automatic increase of 0.1% in the wage tax rate for the year following the loan to bolster the Trust and repay the loan. Additional tax rate increases of 0.1% could be made in each future year until the problem is solved. There could also be a mirror provision making reductions in the wage tax rate whenever the Trust Fund exceeds some set limit. These changes would be modest and affordable, and would permanently assure that the Social Security benefits would be paid. Never again could anyone say, "Social Security is going bankrupt!"

INDIVIDUAL ACCOUNTS

What about individual investment accounts?

The President's Proposal

President Bush has proposed that workers now under 55 could elect to divert up to 4% of their earnings, but no more than \$1,000 annually, into individual investment accounts. The \$1,000 limit would increase in the future. To make up for the lost income to the Trust, the guaranteed Social Security benefits for those who participate would be reduced. This reduction would be in addition to any reduction made by Congress to solve the problem of the projected deficit of the Trust.

To invest their accounts individuals could choose between a small number of diversified funds invested in government bonds, corporate bonds, or stocks, administered by the government. At retirement individuals could apply part or all of their balances to purchase an annuity. They would be required to purchase an annuity to whatever extent needed to bring their combined income from their remaining guaranteed benefits plus the new annuity up to the poverty level. The cost of the annuities would depend upon interest rates at the time of purchase, and could vary from month to month. Any remainder of the account not used to purchase an annuity could be withdrawn in a lump sum or installments. Upon death any balance of a person's account could be paid to beneficiaries.

This proposed change would reduce the projected income and projected outgo of the Trust by approximately equal amounts, so it would not affect the projected long-term imbalance. However it would require large loans to the Social Security Trust.

Individual Accounts as a Substitute for Guaranteed Benefits

Individual account savings plans can provide a very helpful supplement to the benefits payable under Social Security, and they should be encouraged. However, they are not a suitable substitute for any or all of the Social Security benefits for three important reasons.

First, the amount of benefits depends upon the rate of investment return. Rates of return are inherently uncertain, and more so when the individual can choose between several investment alternatives and switch between the alternatives. To the extent that the account balance is applied to purchase an annuity, fluctuation in market values and changes in the interest rate could result in a large swing up or down in the benefit amount if one defers his retirement by one month. The individual accounts proposed by the President might provide more or less than the accompanying reduction in guaranteed Social Security benefits.

Second, retired individuals need an income that continues for life and keeps pace with inflation. Any lump sum that is not used to purchase an annuity does not provide this kind of income, and most individuals lack the ability to convert a lump sum into such a monthly flow. If they attempt to do so, there is a major risk that they will exhaust their account before they die and the payments will stop entirely.

Third, individual accounts provide no good alternative for the disability and survivor benefits that make up one third of all Social Security benefits.

Individual investment accounts can be a good addition to Social Security's guaranteed benefits, but they should not be substituted for any of those benefits.

CONCLUSIONS

To summarize, Social Security appears to have a significant imbalance in the years ahead, but the amount of that imbalance is unknown. Resolving the problem is not urgent – certainly less urgent than the solving the problems of Medicare’s Hospital Trust.

Reducing benefits could close Social Security’s projected imbalance, but this would be very bad for the retirement security of Americans, and such benefit cuts are not necessary. I recommend substantially reducing the projected deficit by increasing the cap on taxable wages or other steps to increase the income of the Trust. Congress should also adopt an automatic adjustment mechanism that will permanently keep the system in balance. Replacing any of the guaranteed Social Security benefits with individual investment accounts would be unwise.

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**Baby Boomer Retirement:  
The Nightmare in Our Future**

by

**John C. Goodman  
President  
National Center for Policy Analysis**

**Testimony**

**Before the**

**House Ways & Means Committee**

**Thursday, May 19, 2005**

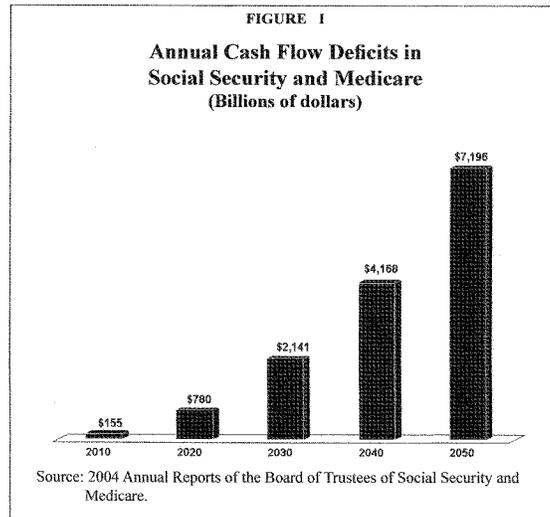
In 2011, the first group of baby boomers will reach the age of 65. Some will begin claiming early retirement in just three years. By the time they are through, 77 million of them will have ceased working and paying taxes and will have begun receiving taxpayer-funded health care and pension benefits. This will create a financial train wreck for Social Security, Medicare and Medicaid and all other programs for the elderly. Other countries in the developed world face even bigger problems. In Japan, Europe and North America, the number of retirees will double over the next 25 years while the number of taxpayers will grow by only 10 percent. The economic consequences of these changes are dire: higher taxes, slower growth and lower living standards relative to what otherwise would have occurred.<sup>1</sup>

In the United States, we have made promises to senior citizens that far exceed what we can pay for at current tax rates. As a result, future retirees will have to rely more on private savings than previous generations. For this reason, we need programs that encourage private sector saving. The ideal would be to encourage private saving and reduce future government entitlement obligations at the same time. This could be accomplished with personal retirement accounts.

**The Cash Flow Problem.** In a pay-as-you-go system, what matters most is cash flow. And the cash flow drain that elderly entitlement programs portend is not a problem of the distant future, as some argue. The problem has already begun.

Social Security and Medicare have been receiving more in payroll taxes than they have been paying out in benefits for several decades. Last year, the two programs combined spent more than they took in, requiring a general revenue subsidy of about \$45 billion. The magnitude of the deficits in these two programs will soar in the years to come.

For those who believe that Social Security and Medicare are in sound financial shape for decades to come, Figure I presents a sobering picture. In fact, the latest numbers from the Trustees of Social Security and Medicare are staggering. In 2010, the federal government will need \$127 billion in additional funds to pay promised benefits. Five years later, the size of the annual deficit will double. Five years beyond that, it will double again. In just 15 years, the federal government will have to raise taxes, reduce other spending or borrow \$761 billion to keep its promises to America's senior citizens. As the years pass, the size of the deficits will continue to grow. Without changes in worker payroll tax rates or senior citizen benefits, the shortfall in Social



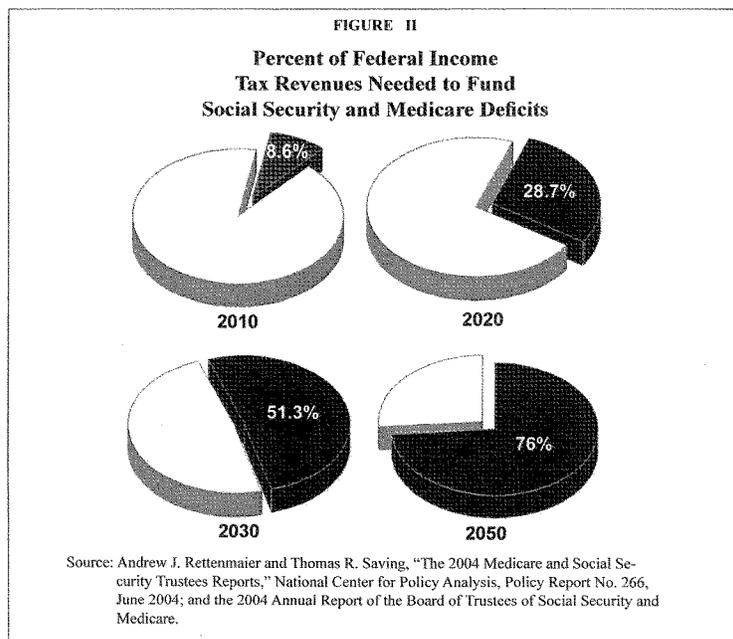
Security and Medicare revenues compared to promised benefits will top more than \$2 trillion in 2030, \$4 trillion in 2040 and \$7 trillion in 2050!<sup>2</sup>

These deficit numbers include projected inflation. Yet even in 2004 dollars, the numbers are still staggering. Valued in today's dollars, the annual Social Security deficit will top \$50 billion in 2020, \$250 billion in 2030 and \$400 billion in 2050. Adding Medicare's deficits, the federal government will need more than \$500 billion in 2020, \$1 trillion in 2030 and \$2 trillion in 2050 to fund elderly entitlement programs alone.<sup>3</sup>

Note that these estimates, which come from the latest Social Security Trustees report, do not include the growing burden of senior health care costs under Medicaid.

**Deficits as a Percentage of Other Federal Revenues.** The combined budget shortfalls for Social Security and Medicare are so large that it is difficult to comprehend what the numbers mean. Figure II presents the projected deficits as a percentage of federal income tax revenues. It shows that combined Social Security and Medicare deficits will equal almost 10 percent of federal income taxes in just five years. Roughly this means that, if the federal government is to keep its promises to seniors, it will have to stop doing one in every ten things it does today. Alternatively, we will have to raise income taxes by 10 percent or borrow an equivalent sum.

Ten years later, in 2020, combined Social Security and Medicare deficits will equal almost 29 percent of federal income taxes. At that point the federal government will have to stop doing almost a third of what it does today. By 2030, about the midpoint of the baby boomer retirement years, federal guarantees to Social Security and Medicare will require one in every two income tax dollars. By 2050, they will require three in every four.<sup>4</sup>



**What about the Trust Funds?** The Social Security and Medicare Trust Funds serve an accounting function, not an economic one. They work like this: When payroll tax revenues exceed expenses, special bonds are created to keep track of the surplus. These bonds are not purchased in the marketplace, however. For Social Security, they are created on paper and placed in filing cabinets in Parkersburg, West Virginia, (for Medicare, they are computer entries only) while the actual surplus payroll tax dollars are spent on other things. When tax revenues fall short of expenses, the process is reversed: the bonds are taken out of the filing cabinets and retired.

The Social Security Trust Fund currently holds about \$1.6 trillion of these bonds. But the bonds cannot pay benefits. They cannot be sold on Wall Street or to foreign investors. Although they are treated as assets of the Trust Fund, they are also liabilities of the Treasury. Summing over both agencies of government, assets plus liabilities net out to zero. If the federal government had purchased assets with the Social Security surpluses, the trust funds would today represent real economic value. Instead, Social Security revenues were spent in other ways and the government essentially wrote IOUs to itself.

If a fire were to destroy the filing cabinets in Parkersburg, it would in no way diminish the capacity of the federal government to pay benefits. Alternatively, if a stroke of the President's pen were to double or triple the number of bonds in those filing cabinets, that would in no way increase our ability to pay benefits. If we could create value by writing IOUs to ourselves, Social Security would have no financial problems. Unfortunately, there is no free lunch.

**Present Value of Unfunded Liability.** Last year, for the first time since the inception of these programs, the Social Security Trustees did something private entities do routinely — they calculated the present value of the difference between the promises we have made and the expected revenues dedicated to keeping those promises. These calculations were made for the traditional 75-year horizon and (what economists consider the more accurate procedure) looking indefinitely into the future. These implied, unfunded liabilities are enormous:<sup>5</sup>

- Social Security's long-run cash flow deficit is \$11.1 trillion — almost equal to the current size of the entire U.S. economy.
- The total shortfall of Medicare Part A (hospital insurance) and Part B (doctors' services) is \$47.7 trillion; and the new prescription drug benefit will require \$17.7 trillion.
- The unfunded liability of Medicare and Social Security combined totals more than \$76.5 trillion — more than seven times the size of our economy.

This means that without ever raising taxes or cutting benefits, we need \$76.5 trillion invested right now at the government's borrowing rate. And because we have not made that investment, our unfunded liability under Social Security is growing at the rate of \$667 billion per year. The unfunded liability under Medicare is growing at a rate of \$4 trillion per year.

**Moving to a Funded System.** The underlying problem in the United States and throughout the developed world is reliance on pay-as-you-go finance. Every dollar that is collected in payroll taxes is spent. It is spent the very day, the very hour, the very minute it is received. No money is being stashed away in bank vaults. No investments are being made in real assets.

In a pay-as-you-go system, promises made today can be kept only if future taxpayers (many of whom are not yet born) pay a much higher tax rate than workers pay today. And even if they do shoulder a much greater burden, they would have no assurance that their benefits would be paid as the necessary tax burden grows through time. In any event, this chain letter approach to paying for retirement benefits must eventually come to an end. The question is: can we find an orderly way to transform the system that minimizes the pain.

The alternative to a pay-as-you-go system is a funded system, where worker contributions are saved and invested. Instead of depending on future generations of taxpayers to pay ever-escalating tax rates, in a funded system each generation pays its own way.

Thirty countries have already gone through the process of transforming their pay-as-you-go systems into partially or fully funded systems. These countries have acted responsibly to deal with a problem that the United States so far has refused to face.<sup>6</sup>

**Personal Retirement Accounts.** It is possible to fund a retirement system without creating individually owned and controlled accounts. After World War II, almost two dozen former British colonies set up forced savings plans (called provident schemes) as an alternative to the pay-as-you-go approach so popular elsewhere around the world. The most successful of these was established by Singapore.<sup>7</sup>

Despite the evolution and success of Singapore's system, in most cases provident funds have had a spotty and disappointing record. The reason: when funds were managed and controlled by governments, all too often politicians succumbed to the temptation to spend the funds rather than invest them.

Personal retirement accounts create a check on government power. By creating ownership rights and reinforcing the principle of ownership by allowing individual worker investment choices, the odds greatly increase that funds invested today will be able to pay retirement benefits tomorrow.

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#### Notes

<sup>1</sup> Laurence Kotlikoff, Hans Fehr and Sabine Jokisch, "Aging, the World Economy and the Coming Generational Storm," National Center for Policy Analysis, Policy Report No. 273, February 4, 2005.

<sup>2</sup> The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds and the 2004 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds.

<sup>3</sup> Ibid.

<sup>4</sup> The Trustees reports express these deficits as a percent of GDP. Here they are converted to a percent of federal income tax revenues, assuming federal revenues are 10.8% of GDP, which is the 50 year average.

<sup>5</sup> Social Security Trustees Report Table IV.B7, and 2005 Medicare Trustees Report Tables II.B12, III.C17 and III.C23.

<sup>6</sup> Estelle James, "Reforming Social Security: Lessons from Thirty Countries," National Center for Policy Analysis, Policy Report No. 277, May 2005.

<sup>7</sup> Peter J. Ferrara, John C. Goodman and Merrill Matthews, Jr., "Private Alternatives to Social Security in Other Countries," National Center for Policy Analysis, Policy Report No. 200, October 1995.

