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Report to the Chairman and Ranking
Minority Member, Special Committee on
Aging, U.S. Senate

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RETIREMENT INCOME

Implications of Demographic Trends for Social Security and Pension Reform





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The Honorable Charles E. Grassley
Chairman
The Honorable John B. Breaux
Ranking Minority Member
Special Committee on Aging
United States Senate

Our nation's elderly population is growing dramatically. In 1940, when Social Security first paid benefits, it was 7 percent of the U.S. population; today it is 13 percent. By 2030, the elderly population will be 20 percent of the population. This demographic trend has profound implications not just for Social Security but for all sources of retirement income, which also include pensions, savings, and earnings. While currently most of our nation's senior citizens enjoy a reasonable standard of living, this trend raises concerns that our society will continue to be able to maintain it. This report provides an overview of the trends and key issues relating to retirement income.

We are sending this report to the Commissioner of Social Security and relevant committees and subcommittees. The report will be available to others on request.

This report was prepared under my direction. Please contact Francis P. Mulvey, Assistant Director, at (202) 512-3592 if you have questions.

Jane L. Ross
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Executive Summary

Purpose

The U.S. elderly population has tripled since 1940 and will more than double by 2050, according to Bureau of the Census projections. The very old population (aged 85 and over) will increase fivefold. The elderly are expected to make up 20 percent of the U.S. population as early as 2030 compared with 13 percent today and just 7 percent in 1940. These dramatic demographic trends pose serious concerns about the future financing, availability, and protection of retirement income for the nation's elderly. Numerous reform proposals under discussion could fundamentally change the nation's retirement system.

The Chairman and Ranking Minority Member of the Senate Special Committee on Aging, concerned about these issues, asked GAO to provide information on (1) demographic and economic trends affecting retirement income, (2) the status of Social Security's long-term financing problems and proposals to address them, and (3) the extent of pension coverage and retirement saving and how to ensure that Americans can count on them throughout their retirement years.

Background

The four major sources of retirement income are Social Security, employer pensions, income from saved assets, and employment earnings. While Social Security provides income to 90 percent of elderly households, it provides just 42 percent of their aggregate cash income. Pensions, savings, and earnings provide income to considerably fewer households but together provide more than 50 percent of the elderly's aggregate income. They largely determine which households have the highest retirement incomes.

As people live longer and if retirement patterns do not change, Social Security and employer pensions will cost more or will have to provide reduced benefits or both. Personal retirement savings will have to last longer, and workers may find themselves needing to work longer. Federal policies play a major role in all these sources of retirement income and will play a significant role in helping adjust to demographic trends.

Title II of the Social Security Act established the Old-Age, Survivors, and Disability Insurance program, which is generally known as Social Security. Initially, it provided old-age benefits to nearly all workers in commerce and industry, or about 60 percent of the workforce. Over the years, coverage has been expanded to dependents and survivors of insured workers, disabled workers, and workers in other types of employment.

With regard to pensions, the federal government has an interest in promoting expanded coverage of workers so they can better meet their retirement income needs. The Employee Retirement Income Security Act (ERISA) of 1974 focused new attention on making pension promises more explicit and benefits more secure. In addition to its minimum funding requirements and other provisions, ERISA established a system of pension insurance, administered by the Pension Benefit Guaranty Corporation (PBGC). PBGC assumes liability for certain types of pensions when they are terminated and pays the pension benefits, subject to certain limits.

Federal tax policy also affects how people save for retirement. Since the 1970s, federal laws have granted favorable tax treatment to individual retirement accounts (IRA) and the closely related 401(k) pension plans. Nevertheless, personal saving rates are at a historic low. Finally, federal policies also affect postretirement earnings. Most notably, provisions in the Social Security program affect incentives regarding when workers take benefits and how much beneficiaries choose to earn after retirement.

Results in Brief

As the elderly live longer, they will need retirement income over longer periods. Since fertility rates have been declining, the number of the elderly will grow as a share of the population. While the income of the elderly has improved considerably over the past 50 years, demographic trends may potentially slow or reverse such improvements. Economic growth, if strong, could ease some of the pressures these trends create. Still, the nation must confront how the trends will affect the distribution of income between workers and retirees, between the population's working and retirement years, and between high and low earners.

These trends pose long-term financing challenges for both Social Security and the federal budget. Currently, Social Security revenues exceed expenditures. The excess revenues are invested by law in federal government securities and make the total federal deficit lower than it would be otherwise. However, in just 15 years, expenditures are expected to exceed cash revenues, according to Social Security Administration (SSA) projections. At that point, the government's general fund will have to make up the difference—in effect, repaying funds owed to Social Security. Such repayment will present a significant and growing challenge for the overall federal budget. By 2029, without corrective action, the trust funds will be depleted, and Social Security's revenues will fund only 70 to 77 percent of benefits.

To restore Social Security's long-term financial balance, a number of reform options are available within the current structure of the program, such as expanding the number of covered workers or further increasing the retirement age. However, some proposals go beyond restoring financial balance and call for fundamentally restructuring the Social Security system. These proposals attempt to shift more of the responsibility for retirement income from the federal government to individuals.

Social Security is meant to provide only a foundation for retirement income. Pensions, savings, and earnings also represent significant sources of retirement income and largely determine which households have the highest retirement incomes. Solutions to Social Security's problems will inevitably affect these other sources and could give them an even more significant role. More workers will eventually receive income from pensions because of legislative changes regarding vesting and spouse benefits and also because of women's increasing labor force participation. Nevertheless, the proportion of workers covered by pensions at a given moment has not increased substantially since 1970. In addition, the national saving rate is at a historic low. Moreover, some trends threaten to diminish retirement income from pensions and savings. For example, workers increasingly borrow from their pension savings, cash out their pensions when they change jobs, or, at retirement, take their pensions as lump-sum payments rather than a guaranteed life annuity.

Ensuring that Americans have enough retirement income in the twenty-first century to meet their needs will require that the nation and the Congress make some difficult choices. Social Security has been an effective agent for ensuring a reliable source of income in retirement and greatly reducing poverty among the elderly. The effect of changes to the system on other retirement income sources and their effects on various groups within the elderly population should be well understood before decisions are made. Further, the interplay of budget and savings effects will have to be carefully considered before any reform proposal is adopted.

Principal Findings

Demographic and Economic Trends Present Serious Challenges

Increasing life expectancy and declining birth rates are responsible for the substantial growth in the number of the elderly as a share of the total population. The baby-boom generation will simply accelerate this trend. The elderly will need retirement income over longer periods and will consume an increasing share of the national output. By 2030, only two workers are projected to be paying into Social Security for each person receiving benefits, compared with more than three workers today, according to SSA actuaries.

Healthy economic growth could ease the pressures of supporting more retirees with fewer workers. Unfortunately, the rate of national saving and the growth in real wages and productivity, factors that relate to economic growth, have slowed notably in the past two decades. Even with strong economic performance, decisions affecting retirement income policies still have to be made and will fundamentally influence how the national output will be divided. They influence how much of total compensation workers consume now and how much they will consume during retirement. They also influence how income is redistributed between current workers and current retirees and between high earners and low earners.

Social Security and pension benefits have helped increase the income of the elderly over the past 50 years. For example, the share of the elderly living in poverty has fallen from 35 percent in 1959 to less than 11 percent today. Still, pockets of poverty remain, especially among those aged 75 and over and among unmarried women.

Addressing Social Security's Long-Term Financing Problem

The growth of the elderly population as a share of the total population poses serious long-term financing challenges for Social Security. In January 1997, the Social Security Advisory Council issued its report on the system's long-range financial status, but the council members could not reach agreement on a comprehensive solution. Still, five individual reform options enjoyed considerable support and, if enacted, would eliminate about two thirds of the next 75 years' financing shortfall. These reforms would modify (1) the retirement age, (2) cost-of-living adjustments (COLA), (3) the benefit formula, (4) income taxation of benefits, and (5) which workers are covered under Social Security.

While these reform options would work within the current structure of the program, “privatization” proposals go further and would significantly restructure Social Security. Such proposals would achieve financial balance by raising revenues or reducing costs while pursuing other goals, such as increasing national saving or giving individuals more responsibility for their retirement income. For example, such proposals would typically increase the role of individual retirement saving while reducing government-provided benefits. For many of these privatization proposals, the transition from the current program to the new system would be quite expensive. The contributions needed to fund both current and future liabilities would clearly be higher than those currently collected.

The Social Security Trust Fund Build-Up and the Federal Deficit

Solving Social Security’s long-term financing problem would not necessarily address another significant challenge that the program presents for the overall federal budget. Currently, Social Security cash revenues exceed expenditures by roughly \$30 billion each year. Under current law, the Department of the Treasury issues interest-bearing government securities to the trust funds for these excess revenues. In effect, Treasury borrows the excess revenues and uses them to help reduce the amount it must borrow from the public. Moreover, the trust funds earned \$38 billion in interest last year, which Treasury pays by issuing more securities. If Treasury could not borrow from the trust funds, it would have to borrow more in the private capital market and pay such interest in cash.

However, 10 years from now, these excess cash revenues are expected to start falling, and in just 15 years, Social Security’s expenditures are expected to exceed its cash revenues. The government’s general fund will have to make up the difference, in effect repaying Social Security. As a result, the federal deficit will increase, unless offset by spending reductions or revenue increases. In 2028, repayments from the general fund to Social Security are expected to reach about \$183 billion in 1997 dollars. In that year, this amount would equal 1.4 percent of gross domestic product (GDP), which is the same share of GDP as last year’s deficit for the entire federal government.

Strengthening Employer Pensions and Personal Retirement Savings

Employer pensions and personal retirement savings are also significant sources of retirement income. About 47 percent of workers had private pension coverage in 1993. Although this coverage rate has changed little since the 1970s, more workers will eventually receive income from

pensions because of legislative changes in the 1980s regarding vesting and spouse benefits and also because of women's increasing labor force participation. Still, these changes also imply smaller average pension benefits because they will reflect the shorter job tenures of these workers who would not have received pensions previously. Also, joint-and-survivor annuities yield smaller monthly benefits than worker-only annuities. In addition, complex pension regulations may deter employers from sponsoring pensions. Current proposals to expand pension coverage focus on simplifying some of the regulations.

Efforts to increase personal savings outside pension arrangements seem to have had only marginal success. Many households do not save in any systematic way, and personal saving rates have declined by nearly half since 1970. Preferential tax treatment for 401(k) and individual retirement accounts seems to encourage saving, but such saving may substitute, at least partly, for other types of saving.

To help meet the nation's retirement income challenges, pensions and savings must be secure and wisely managed. While tax laws discourage using pension assets for nonretirement purposes, the laws do not strictly prohibit such use. Some workers cash out their pension accounts when they change jobs, despite penalties and tax liabilities. At retirement, most take their pensions as a lump sum, which they must carefully manage to provide income for the rest of their lives. In addition, most plans allow workers to borrow from their accounts for specified purposes. The loan option may encourage workers to contribute more to these accounts and, in some cases, such as borrowing for educational expenses, could result in greater retirement income security. However, if they do borrow, they may reduce the savings available for retirement.

In the case of retirement savings and some pension plans, workers control how their savings are invested. However, many workers may lack the information necessary to get higher investment earnings. Research shows that educating employees in how to manage their funds can increase both their retirement contributions and investment returns.

Recommendations

GAO is not making recommendations in this report.

Agency Comments

GAO obtained comments on this report from SSA and from subject matter experts. They did not express any disagreement with the overall message

of the report. They did suggest some technical corrections, which have been incorporated as appropriate.

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Abbreviations

AIME	average indexed monthly earnings
COLA	cost-of-living adjustment
CPI	Consumer Price Index
DB	defined benefit
DC	defined contribution
DOL	Department of Labor
ERA	early retirement age
ERISA	Employee Retirement Income Security Act
GDP	gross domestic product
IRA	individual retirement account
IRS	Internal Revenue Service
NRA	normal retirement age
PBGC	Pension Benefit Guaranty Corporation
PIA	primary insurance amount
SEP	simplified employee pension
SIMPLE	savings incentive match plan for employees
SSA	Social Security Administration
TSP	Thrift Savings Plan

Introduction

As the U.S. population ages, there will be growing pressures on Social Security and pension programs to provide retirees with the retirement income they need. For more than 60 years, the Social Security program has helped protect America's elderly from living in poverty, but it now faces a long-term financing problem. Proposals to address the problem are wide-ranging, and many, if adopted, could fundamentally change the nation's retirement system.

The Sources of Retirement Income

When individuals retire from their principal employment, they may receive income from one or more of several sources, primarily Social Security, pensions, personal savings, and earnings from subsequent work. Federal policies play a major role in all these sources of retirement income. Moreover, they affect how income is distributed between workers and retirees, between high and low earners, and between individuals' working and retirement years.

The Social Security Act was signed into law by President Franklin D. Roosevelt in August 1935 in response to the crisis Americans faced during the Great Depression. The retirement component of the act initially provided benefits upon retirement to workers in commerce and industry who had contributed to the program over a portion of their working lives.

Social Security was meant to provide a retirement income foundation upon which individuals could build for their retirement years. It was a social insurance program. Over the years, the size and scope of the program has changed. In 1939, coverage was extended to provide benefits for some family members and survivors. In the 1950s, state and local governments were given the option of covering their employees. The Disability Insurance program was added in 1956, providing income for disabled workers. The Medicare program was added in 1965. Beginning in 1975, benefits were automatically tied to the Consumer Price Index (CPI) to ensure that the purchasing power of recipients' income was not eroded by inflation.

Because the Social Security program was designed as a pay-as-you-go system with current benefits paid out of current income (primarily from payroll taxes), it experienced periodic financing difficulties as coverage and benefits increased and as the number of retirees increased relative to the number of contributors. Payroll taxes increased from an initial 2 percent on the first \$3,000 of earnings (1 percent each from employers

and employees) to 12.4 percent on the first \$65,400 of earnings today. For many Americans, the payroll tax is now the largest tax they pay.

Some of the increases in payroll taxes were always anticipated as a natural result of the maturing of the Social Security system and its pay-as-you-go financing. The first benefits were paid only to individuals who had already made some contributions to the system. In the early years, a very small share of the elderly qualified for benefits, and larger payroll taxes were not required. As more and more of the elderly received benefits, higher payroll taxes were required. While such increases had always been anticipated, some of the payroll tax increases resulted from benefit increases, especially cost-of-living adjustments, and eligibility expansion such as survivor and disability benefits.

Pensions are the second major source of retirement income. Private pensions grew rapidly in popularity between 1900 and 1920 until about one worker in six was covered—typically those working in the transportation, banking, mining, utility, and manufacturing industries. Pension coverage basically held its own during the Great Depression and again grew rapidly between 1940 and 1960 and continued to increase into the 1970s when coverage leveled off at just under half the workforce. Workers nearing retirement are the most likely to have pension coverage.

The federal government has an interest in promoting expanded pension coverage of workers so they can better meet their retirement income needs and because expanded coverage increases national saving. In addition, the Employee Retirement Income Security Act of 1974 (ERISA) focused new attention on making pension promises more explicit and benefits more secure. This act established guidelines for operating pension funds and set specific requirements for various pension plan provisions. These new rules and subsequent regulations have raised the costs of employer-provided defined benefit plans and have affected the growth of defined contribution plans, including 401(k) plans. Under defined contribution plans, the benefits are not certain, as they are under defined benefit plans; they vary depending on the level of contributions made to the pension and the performance of the investment portfolio.

The rate of personal saving, the third source of retirement income, is at a historic low. Moreover, the very low rate of national saving has raised concern among many economists about the long-term effects on national economic growth because saving helps spur investment, which in turn contributes to economic growth.

Finally, the last source of retirement income, employment earnings, may become increasingly important if the other sources fail to provide sufficient income to meet the needs of future retirees. Federal policies affect such earnings in that Social Security provisions affect when workers retire and how much they choose to earn after retirement. Also, federal policies regarding health insurance, whether concerning Medicare, Medicaid, or employer-provided retiree health insurance, influence when workers retire.

Objectives, Scope, and Methodology

The Chairman and Ranking Minority Member of the Senate Special Committee on Aging asked us to review current and emerging issues relating to retirement income. First, we identified the economic and demographic trends affecting retirement income. Second, we examined the status of Social Security's long-term financing problems and proposals to address it. Third, we examined the extent of pension coverage and retirement saving and how to ensure that retirees can count on them throughout retirement.

In conducting this study, we reviewed the literature and public record relating to retirement income policy. We also examined data on retirement income sources and the demographics of the elderly population. Our data sources included official Social Security data, especially from the 1996 Trustees' Report, Census data, and data from the Health and Retirement Survey, prepared by the University of Michigan Survey Research Center. We looked at relevant legislation and proposals affecting retirement income. We discussed retirement income issues with several experts from government, research institutes, and benefit consulting firms. We conducted our work between March 1996 and May 1997, using generally accepted government auditing standards.

Demographic and Economic Factors Affect Retirement Income

The U.S. elderly population has tripled since 1940 and will more than double again by 2050, according to Census projections, and is accounting for a growing share of the total population.¹ As people live longer and have fewer children, the number of workers per retiree is declining. Moreover, the elderly will consume an increasing share of the national output. A healthy rate of real economic growth could help ease the pressures created by these challenges, but the prospects for such growth are unclear. Whatever the outcome, federal retirement policies will help determine how national income will be distributed. In fact, the growth in Social Security and private employer pensions since 1940 has contributed substantially to increasing income and reducing poverty among the elderly.

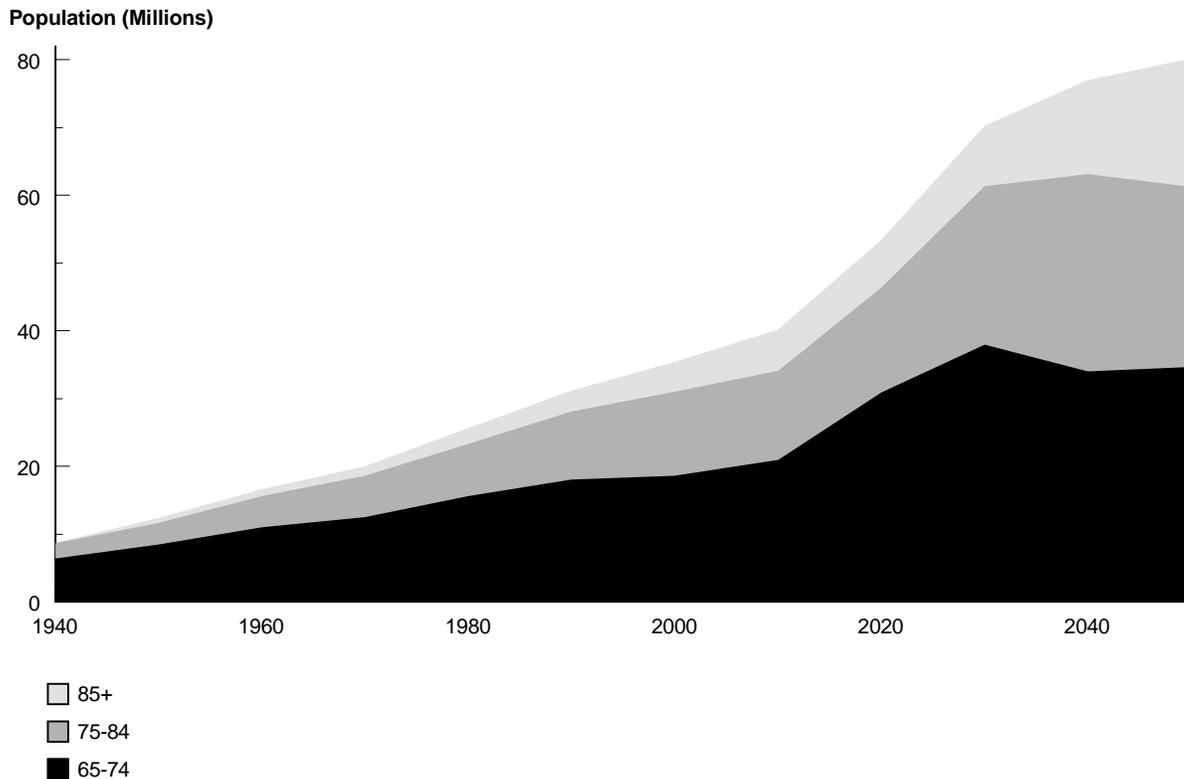
The Elderly Population Is Growing in Number and Proportion

In the United States, the elderly population grew from about 9 million in 1940 to about 34 million in 1995, and it is expected to reach 80 million by 2050, according to Census projections.² Moreover, the very old population (those aged 85 and over) is expected to increase fivefold, from about 4 million in 1995 to nearly 19 million in 2050. (See fig. 2.1.) As a share of the total U.S. population, the elderly population grew from 7 percent in 1940 to 12 percent in 1990; this share is expected to increase to 20 percent by 2050. Other nations, both developed and developing, are experiencing similar and often more pronounced trends.

¹In this report, we use “elderly” to refer to people aged 65 and over. However, the “retired” population is not so clearly defined; many retire before reaching age 65 and some continue working afterward. We use age 65 primarily because age group data often use age 65 as a break point.

²In its population projections, Census uses alternative assumptions of high, middle, and low rates of fertility, mortality, and immigration. These projections reflect the middle assumptions set. Some demographers project even more dramatic growth in the elderly population than Census or Social Security actuaries do. In particular, the 1994-96 Social Security Advisory Council’s Technical Panel on Assumptions and Methods noted that Social Security’s mortality assumptions reflect a lower rate of mortality improvements than may be warranted.

Figure 2.1: Population Aged 65 and Over, by Age Group, 1940-2050



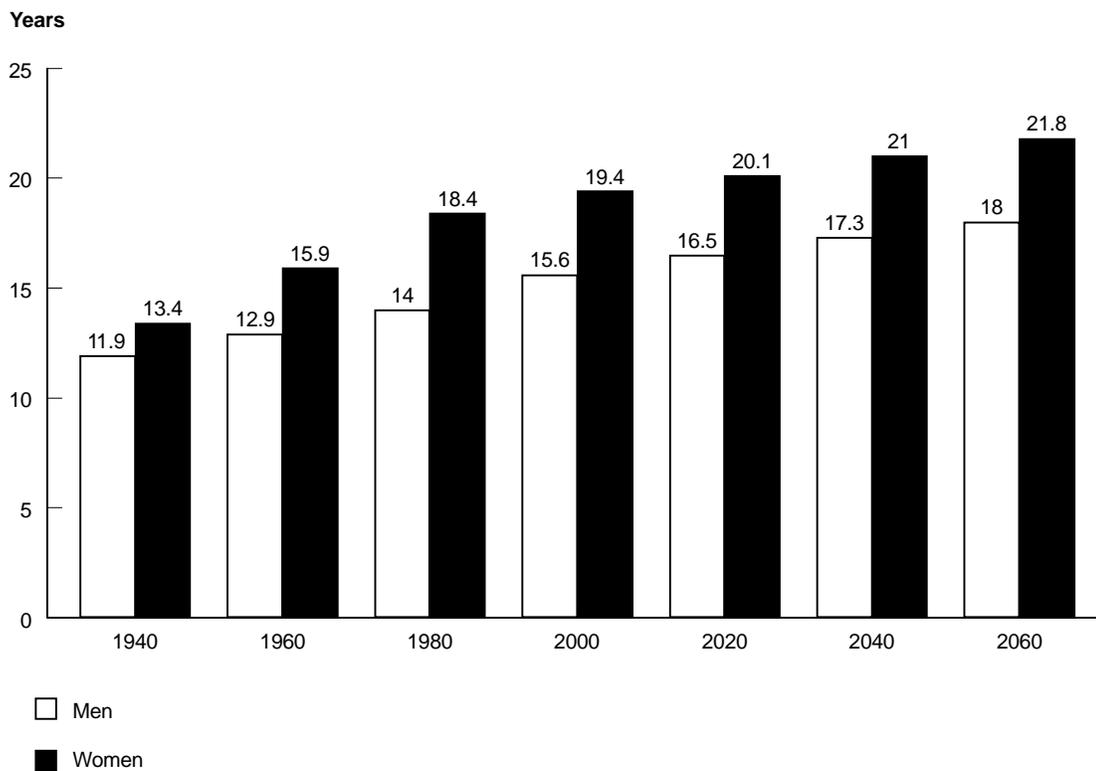
Note: Data for 2000-2050 are midrange Census projections.

Source: U.S. Bureau of the Census, *65+ in the United States* (Washington, D.C.: 1996).

Although the baby-boom generation will contribute heavily to the growth of the elderly population, other demographic trends are also important. Increasing life expectancy, for example, is another major factor. Figure 2.2 shows that life expectancy has increased continually since the 1930s and that further improvements are expected. In 1940, the life expectancy of persons at age 65 was 12 years for men and 13 years for women. By 1995, life expectancy at aged 65 improved to 15 years for men and 19 for women

and, by 2040, it is projected to be 17 years and 21 years, respectively, according to SSA's intermediate actuarial assumptions.³

Figure 2.2: Trends and Projections of Life Expectancy at Age 65, 1940-2060



Note: Projections for 2000-2060 are based on the trustees' intermediate actuarial assumptions.

Source: 1996 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds.

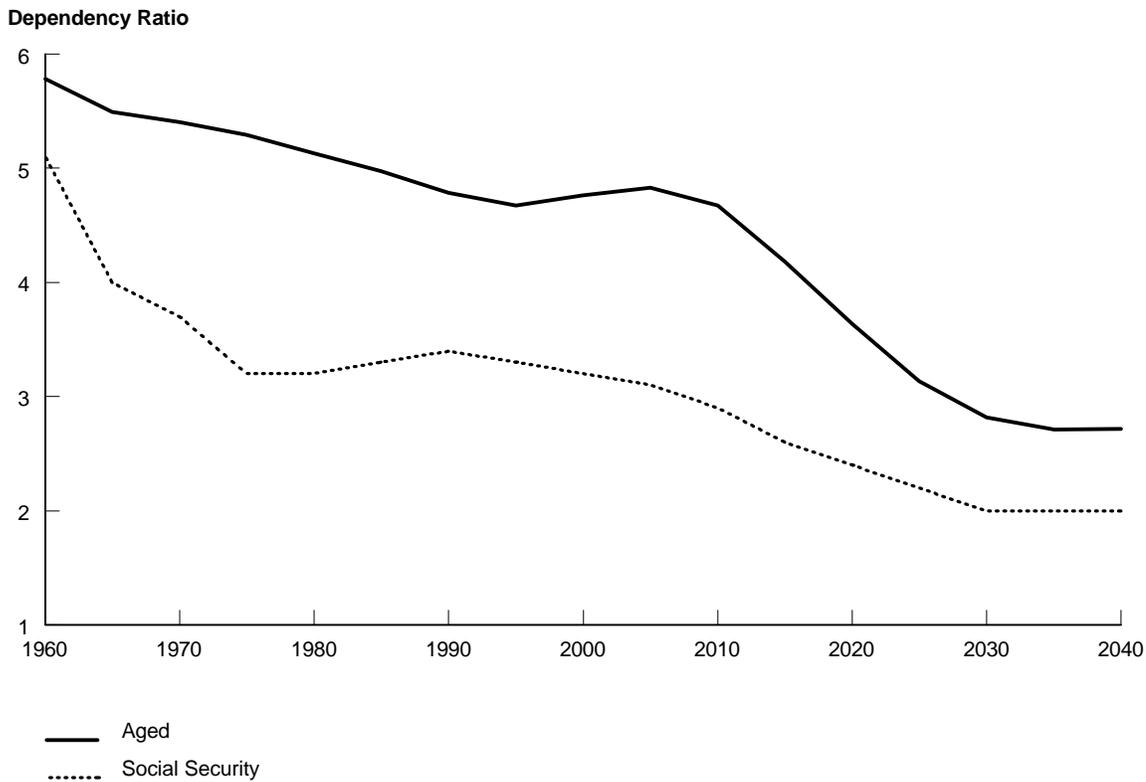
A falling fertility rate is the other principal factor underlying the growth in the elderly's share of the population. Fertility rates rose from about 2.2 children per woman in 1940 to a peak of about 3.6 children per woman

³For the annual report of the Board of Trustees for the Social Security Trust Funds, SSA actuaries project future revenues and benefits. For these projections, they use alternative assumptions regarding economic and demographic trends, including average earnings, mortality, fertility, and immigration. The intermediate assumptions represent the board's best estimate of future trends.

around 1960. Since then, the rate has declined to around 2.0 children per woman today and is expected to level off at about 1.9 by 2020, according to SSA's intermediate assumptions.

The dependency ratio, the number of working-age adults (aged 20 to 64) divided by the number of elderly adults, illustrates the society's increasing burden of supporting the elderly. The dependency ratio declined from 5.8 in 1960 to 4.7 in 1995 and is expected to decline further to 2.7 in 2040. Looking just at Social Security, there were 3.3 workers for each aged or disabled beneficiary in 1995, but by 2030, there are expected to be only 2.0 workers for each beneficiary. (See fig. 2.3.)

Figure 2.3: Historical and Projected Dependency Ratios, 1960-2040



Note: Here, the "aged" dependency ratio is the number of people aged 20-64 per aged person (aged 65 and over). The Social Security dependency ratio is the number of workers paying Social Security taxes per aged or disabled beneficiary. Projections use SSA's intermediate actuarial assumptions.

Source: 1996 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds.

In the future, there will be relatively fewer younger persons to work and support a growing number of aged retirees unless retirement patterns change. In particular, there will be relatively fewer workers to pay the Social Security taxes needed to fund benefits.⁴ At the same time, Social Security, pensions, and other retirement income will have to provide income over longer periods as life expectancies rise. As a result,

⁴Social Security benefits are expected to increase from 4.7 percent of gross domestic product today to 6.4 percent in 2030, according to SSA's intermediate projections.

contributions to Social Security and to pension plans must increase or benefits must be reduced or both. Yet increasing payroll taxes or constraining wage growth could make it harder for workers to save for their own future, while cutting benefits will increase their need to save.

Economic Trends Affect Earnings and Future Retirement Income

Our nation's ability to meet its retirement income challenges depends substantially on how well the economy performs. Retirement contribution rates and benefit levels mostly affect how the nation's output—its economic pie—will be divided. High rates of economic growth would increase the size of the pie. In particular, growth in inflation-adjusted wages (real wages) affects all types of retirement income. Earnings largely determine Social Security and pension benefit amounts and affect how much workers can or want to save. In addition, real wage growth increases the ability and possibly the willingness of workers to absorb any tax increases or benefit cuts that might be necessary for Social Security's long-term financial balance.

Unfortunately, real wage growth has slowed over the last two decades, largely reflecting slowing productivity growth. This contrasts with the 25 years after World War II when the standard of living doubled, helping improve the economic status of today's elderly relative to that of previous generations. However, various measures of real wage growth exist. Measures that incorporate fringe benefits, such as pensions, and that use different inflation estimates suggest that real compensation has slowed but not necessarily stagnated.⁵

As long as real wage growth is positive, living standards do improve. In fact, a Congressional Budget Office study reports that both the real incomes and wealth of the baby-boom generation are notably better than those of their parents at a similar age.⁶ Positive real wage growth, increasing labor force participation by women, and changes in ERISA rules in 1986 that increased the number of workers who will ultimately receive a pension all contribute to the prospect of higher inflation-adjusted retirement incomes for the baby-boom generation.

Income inequality, which has implications for the distribution of retirement income, has widened in recent years. For example, in 1979, of male workers 25 years old and older, the top tenth earned 3.2 times more

⁵Daniel Sullivan, "Trends in Real Wage Growth," *Chicago Fed Letter*, No. 115 (Mar. 1997).

⁶Congressional Budget Office, *Baby Boomers in Retirement: An Early Perspective*, (Washington, D.C.: Sept. 1993).

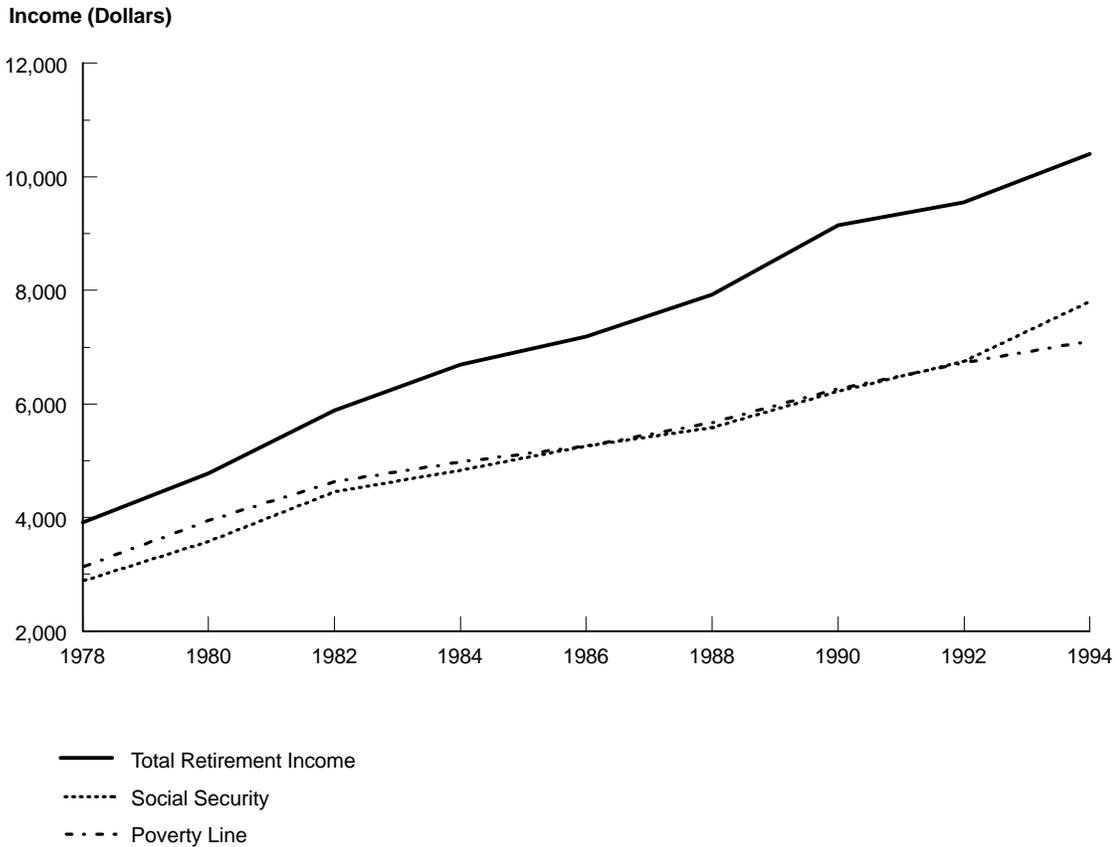
than the bottom tenth, but by 1993, the top tenth was earning 4.1 times as much as the bottom tenth. Explanations for this include, among others, an increased demand for a relatively small number of highly skilled workers as a result of technological change. At the same time, the part of the service sector that employs relatively low-skilled workers has also grown. For persons at the low end of the income distribution, their retirement incomes will be lower, and more of them might qualify for means-tested income support and other programs available to the elderly poor.

The Income of the Elderly Has Improved

Since 1940, Social Security, pensions, and savings have dramatically improved the income of the elderly. Accordingly, poverty rates for the elderly have declined substantially, but pockets of poverty remain. Social Security provides a strong foundation of retirement income, but pensions, savings, and earnings determine which households will be relatively better off in their retirement years. Figure 2.4 shows the increase in total income and Social Security benefits for the elderly relative to the poverty threshold. Because the threshold varies by household composition, this figure uses unmarried persons aged 65 and over only as an example.⁷

⁷About 60 percent of elderly households were nonmarried persons. Of these, 77 percent were nonmarried women. In contrast to nonmarried persons, married couples received median Social Security benefits that exceeded the poverty line in each year and by an increasing amount. This reflects the lower poverty rates of married couples.

Figure 2.4: Median Income Levels and the Poverty Threshold, Unmarried Persons Aged 65 and Over, 1978-94

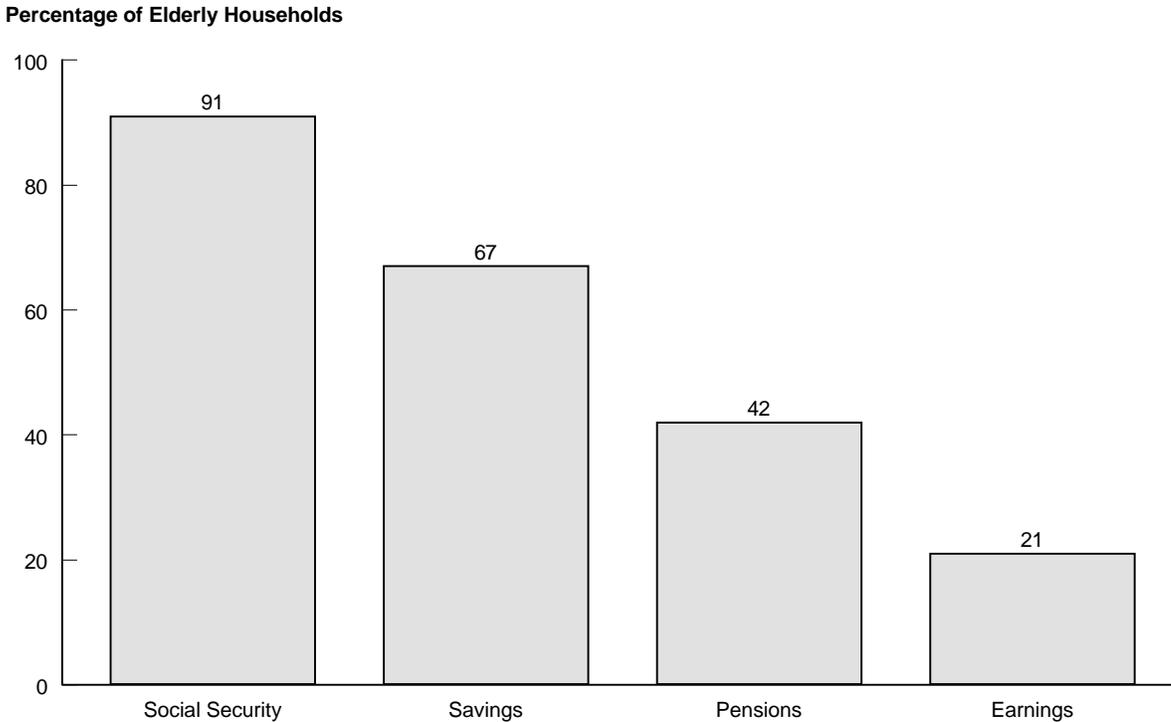


Source: Susan Grad, *Income of the Population 55 and Over* (Washington, D.C.: SSA, Office of Research and Statistics, 1981-96).

Sources of Retirement Income

In 1994, about 91 percent of all elderly households received Social Security benefits, 67 percent received some income from saved assets, just over 40 percent received pensions, and 21 percent received earned income. (See fig. 2.5.) The percentage of elderly persons receiving Social Security benefits has remained stable over the past 20 years while the share receiving income from assets and pensions has increased by about 10 percentage points each. The percentage receiving income from earnings has fallen slightly, reflecting the reduced labor force participation of elderly men.

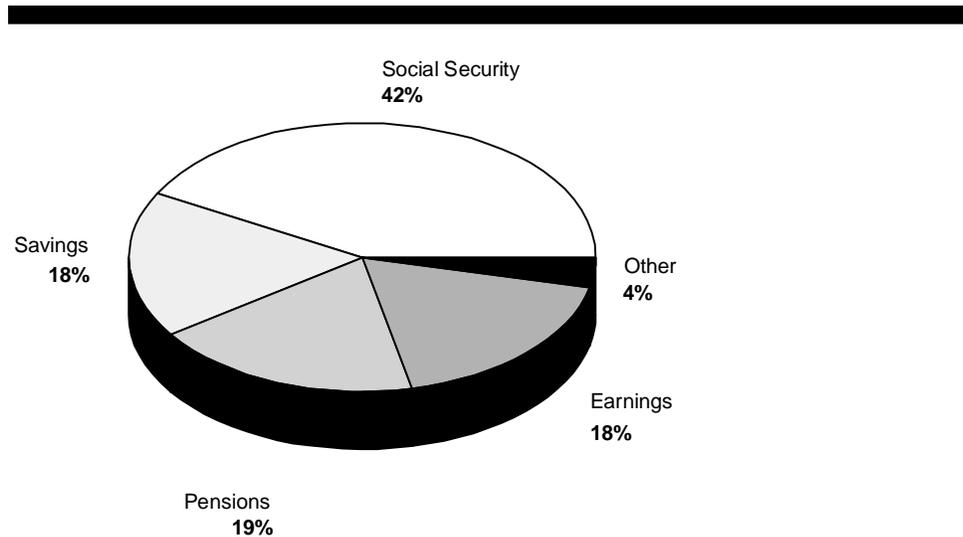
Figure 2.5: Share of Elderly Households Receiving Various Types of Income, 1994



Source: Susan Grad, *Income of the Population 55 or Older, 1994* (Washington, D.C.: SSA, Office of Research and Statistics, 1996).

Social Security benefits contribute the most to the elderly's aggregate cash income, accounting for 42 percent. (See fig. 2.6.) The three other sources contribute about 18 percent each to aggregate elderly income, even though the share of elderly households receiving each type of income varies considerably. Their contributions to aggregate income have fluctuated. For example, savings have ranged between 18 and 28 percent of total elderly income since 1978.

Figure 2.6: Share of Elderly Households' Income by Types of Income, 1994

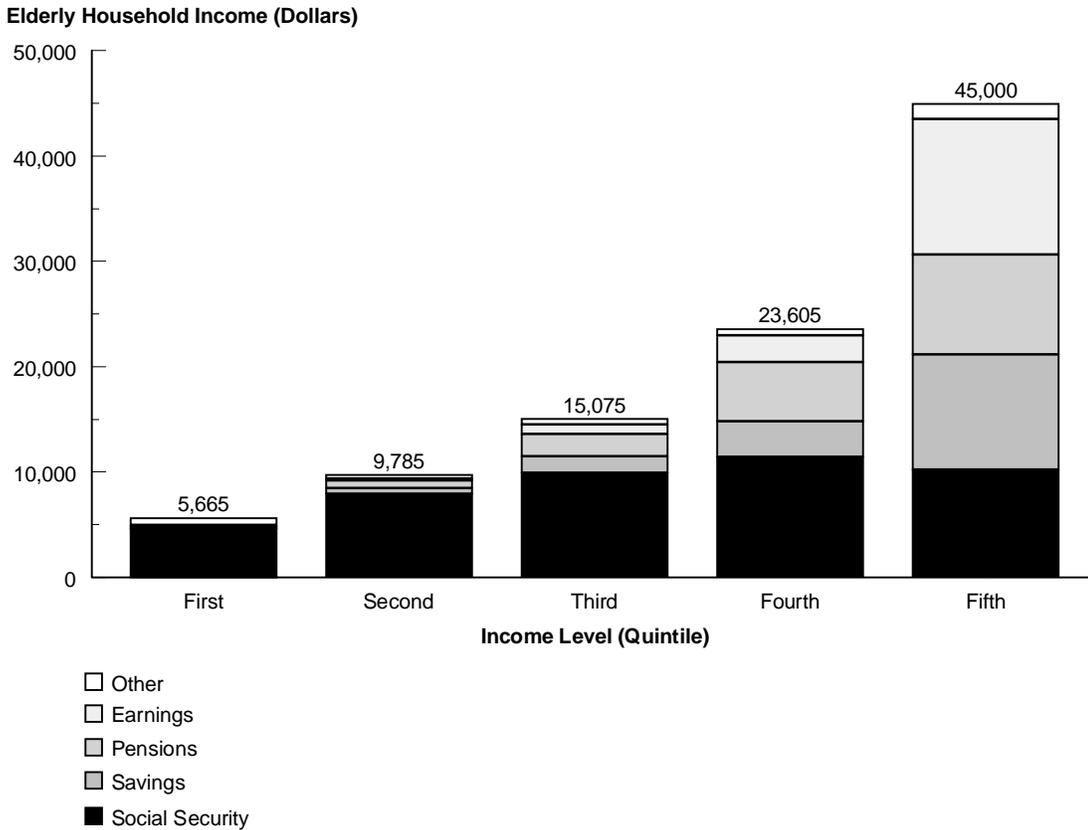


Source: Susan Grad, *Income of the Population 55 or Older, 1994* (Washington, D.C.: SSA, Office of Research and Statistics, 1996).

While Social Security provides a strong foundation for retirement income, it is only a foundation. In 1994, Social Security provided an average of roughly \$9,200 to all elderly households. Figure 2.7 and table 2.1 show the dollar contributions from each source of elderly income by income level for 1994. Social Security's contribution plateaued at roughly \$10,000 in the highest three quintiles. Social Security provided 81 percent of the aggregate income for each of the bottom two fifths of the income distribution but just 23 percent for the top fifth. The second largest source of income for those in the bottom fifth was public assistance, which provided about 11 percent of their total income. Pensions, savings, and earnings determine which households have the highest retirement incomes. They each contributed an average of more than 20 percent of income to the top fifth of the income distribution but less than 4 percent to the lowest fifth. Saved assets, for example, provided income to more than 90 percent of elderly households in the top fifth but to only 30 percent in the lowest fifth.

**Chapter 2
Demographic and Economic Factors Affect
Retirement Income**

Figure 2.7: Pensions, Savings, and Earnings Determine Who Will Have Highest Retirement Incomes, 1994



Note: Median incomes for each quintile are GAO estimates. Social Security income for the highest fifth may be lower than for the previous fifth because, among other possible reasons, some elderly workers or their spouses may not yet be collecting benefits.

Source: GAO analysis of data from Susan Grad, *Income of the Population 55 and Older, 1994* (Washington, D.C.: SSA, Office of Research and Statistics, 1996).

**Chapter 2
Demographic and Economic Factors Affect
Retirement Income**

Table 2.1: Elderly Households' Median Income by Types of Income and by Income Distribution, 1994

	Income level (quintile)				
	First	Second	Third	Fourth	Fifth
Social Security	\$4,600	\$7,936	\$9,934	\$11,401	\$10,215
Savings	153	528	1,553	3,399	10,980
Pensions	181	724	2,126	5,642	9,495
Earnings	11	215	935	2,573	12,825
Other	720	382	528	590	1,485
Total	\$5,665	\$9,785	\$15,075	\$23,605	\$45,000

Note: Median incomes for each quintile are estimates. Social Security income for the highest fifth may be lower than for the previous fifth because, among other possible reasons, some elderly workers or their spouses may not yet be collecting benefits. Totals may not add because of rounding.

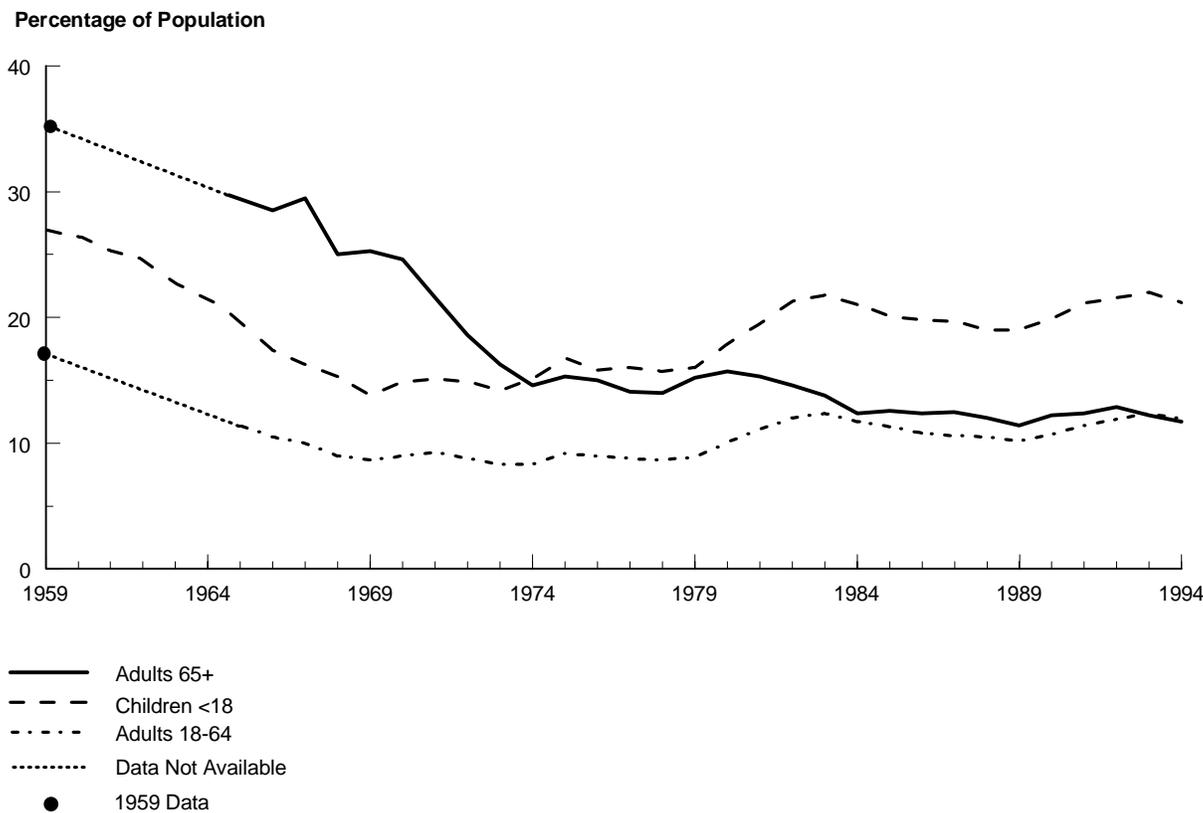
Source: GAO analysis of data from Susan Grad, *Income of the Population 55 and Older, 1994* (Washington, D.C.: SSA, Office of Research and Statistics, 1996).

The Poverty of the Elderly Has Declined, but Pockets Remain

Poverty rates for the elderly declined dramatically from 35 percent in 1959 to under 11 percent in 1995. (See fig. 2.8) In 1994, 11.7 percent of persons aged 65 and over were poor compared with 11.9 percent of adults aged 18-64 and 21.2 percent of children under 18.⁸

⁸The poverty threshold in 1994 was \$8,967 for a two-person elderly household with no related children. The poverty index is based solely on money income and does not reflect noncash benefits such as food stamps, Medicaid, and public housing.

Figure 2.8: Poverty Rates by Age Group, 1959-94



Note: Estimates for adults 65+ and adults 18-64 are not available for 1960-65.

Source: U.S. Bureau of the Census.

Social Security has contributed substantially to reducing poverty among the elderly.⁹ Excluding Social Security benefits, the incomes of about 54 percent of persons aged 65 or older would have been below the poverty threshold in 1994.¹⁰ Still, even with various government benefits, almost

⁹Means-tested public assistance programs such as Supplemental Security Income, Food Stamps, Medicaid, and housing programs also attempt to alleviate poverty for the elderly and others. While these programs are beyond the scope of this report, they are an integral part of income support policies for the poor, including the elderly. Changes in retirement income policy implicitly affect these programs as well as the poverty of the elderly.

¹⁰However, without Social Security, people might save more or continue working.

30 percent of elderly households are poor or near-poor; here, the “near-poor” are persons with incomes between 100 and 150 percent of the poverty threshold.

Poverty tends to affect particular subgroups of the elderly population disproportionately. For persons 75 and older in 1992, 35 percent were poor or near-poor, roughly the same percentage as for children. Poverty status also varies significantly by gender and marital status. Single, widowed, or divorced women are much more likely to live in poverty than couples or unmarried men. About 22 percent of unmarried women aged 65 or older are poor, compared with 15 percent of unmarried men and 5 percent of married couples. Unmarried women make up over 70 percent of poor elderly households.

Health Costs Demand a Growing Share of Retirement Income

Health care costs are substantially greater for the elderly than for others and place growing demands on their incomes, even with public and private health care insurance. Out-of-pocket health costs consumed 21 percent of elderly household income in 1994, according to an analysis of the 1987 National Medical Expenditure Survey and data from other government and insurance industry sources.¹¹ The 1994 values were projected from the 1987 survey data, using trend data from other sources. The elderly pay 42 percent of their noninstitutional health costs, not including premiums.¹² Including premiums, the elderly’s out-of-pocket health costs in 1994 were projected to average \$2,519 per person, which is nearly four times greater than for the nonelderly. After adjusting for inflation, the elderly spent more than twice as much in 1991 on out-of-pocket costs as they did before Medicare was enacted in 1965.

¹¹Out-of-pocket expenses include premiums, deductibles, and copayments as well as costs not covered by insurance at all. However, the data presented here do not include Medicare Part A insurance premium contributions. AARP Public Policy Institute and the Urban Institute, *Coming Up Short: Increasing Out-of-Pocket Health Spending by Older Americans*, No. 9507 (Washington, D.C.: Apr. 1995).

¹²In the case of long-term care, consumers paid 33 percent of the costs out-of-pocket in 1993.

Social Security's Financing Challenges

Social Security plays a major role in providing retirement income. It pays benefits to more than 90 percent of elderly households and provides more than 40 percent of total elderly income. However, the elderly population is growing in both number and proportion, and as a result, the program faces serious long-term financing problems. Because of previous efforts to address long-term financing issues, the Social Security trust funds are building up substantial reserves to help pay future benefits. These reserves are invested in government securities. However, drawing down the trust funds will have significant implications for the federal budget when the time comes to do so.

Addressing Social Security's Long-Term Financing Problems

Although Social Security's revenues currently exceed its expenditures, revenues are expected to be about 14 percent less than total projected expenditures over the next 75 years. In 2031, the last members of the baby-boom generation will reach age 67, when they can receive full retirement benefits under current law. In 2029, the Social Security trust funds are projected to be depleted. In 2030 and each year thereafter, Social Security revenues are expected to be sufficient to pay only 70 to 77 percent of benefits, given current law and SSA's intermediate assumptions about demographic and economic trends.

Restoring Social Security's long-term financial balance will require some combination of increased revenues and reduced expenditures.¹³ A variety of options is available within the current structure of the program. However, some proposals would fundamentally alter the structure of the Social Security program. These more dramatic changes go beyond restoring financial balance and attempt to achieve other policy objectives as well.

In addition to ensuring program solvency, a variety of policy objectives underlie Social Security's program structure or proposals to reform it, such as

- helping ensure that the elderly do not live in poverty;
- promoting benefit "equity"—that is, reducing the variation in the implicit rates of return that participants receive on their contributions;
- giving individuals greater control and responsibility for their retirement income;
- increasing personal and national saving; and

¹³Decreasing the administrative costs of the program will not save much money. Current administrative expenditures are less than 1 percent of program expenditures for Old Age and Survivors Insurance.

-
- reducing future federal budget deficits.

In addition, financing reforms could affect the nation's economy in various ways. For example, increasing national saving or reducing tax burdens could promote economic growth. Reforms that would invest Social Security revenues in the stock market or require increased federal borrowing could affect stock prices and bond interest rates. Raising the retirement age could affect the labor market for elderly workers.

Reforms would have effects on other sources of retirement income and related public policies as well. For example, increasing payroll taxes could affect the ability of workers to save for retirement. Raising Social Security's retirement age or cutting its benefit amounts could increase costs for private pensions that adjust benefits in relation to Social Security benefits. They would also interact with other income support programs such as Social Security's disability insurance or the Supplemental Security Income public assistance program.

Reforms could have both immediate effects and effects far into the future. For example, bringing newly hired state and local government workers into the Social Security system would immediately increase revenues but would increase benefit payments only when the newly covered workers retire. However, even changes that take effect years from now can affect how workers plan for their retirement now, especially how much they choose to save. Therefore, the sooner solutions are enacted, the more time workers will have to adjust their retirement planning. Acting sooner rather than later also means that the funding shortfall can be addressed over a longer period at a lower annual cost.

Finally, any financing reforms would implicitly have distributional effects. For example, increasing Social Security taxes would reduce the disposable income of current workers but would help sustain retirement benefits for current retirees and possibly for themselves when they retire. Cutting benefits instead of increasing payroll taxes would have the opposite distributional effect. Also, Social Security redistributes income from high to low earners to some degree; some reforms would change this redistribution.

Options Within Social Security's Current Structure

A wide range of options is available for reducing costs or increasing revenues within the current structure of the Social Security program. Previously enacted reforms have used many of these in some form.

Current reform proposals also rely, at least in part, on many of these more traditional measures, regardless of whether the proposals largely preserve the current program structure or alter it significantly.

Examples of reducing program expenditures include

- reducing initial benefits by changing the benefit formula for all or some beneficiaries;
- raising the retirement age, which implicitly reduces initial benefits;
- lowering or eliminating the annual COLAs; and
- means-testing benefits.

Examples of increasing revenues include

- increasing income taxes on Social Security benefits,
- increasing Social Security payroll taxes, and
- investing trust funds in the stock market.

Reducing Initial Benefits Through the Benefit Formula

One way to reduce benefits would be to modify the formula used to determine benefit amounts for each retired or disabled recipient. Determining benefit amounts starts by computing a measure of average lifetime earnings. For each year, the worker's covered earnings are updated, or indexed, to reflect the change in average earnings for the national economy.¹⁴ For retired worker benefits, the average is computed using the highest 35 years of indexed earnings. Some propose increasing the computation period to 38 years.¹⁵ Because the current formula uses the years with the highest earnings, additional years would be those with lower earnings and would thereby lower the average. This change would likely decrease benefits more for women than for men, because women usually have more years with zero earnings.

¹⁴Noncovered earnings include any over the maximum taxable earnings (\$65,400 per year for 1997) and any earnings in noncovered employment. Changes in average earnings reflect changes in real wages as well as wage inflation. Therefore, this indexing captures some of the improvement in the standard of living.

¹⁵For example, the Ball proposal included in the recent Social Security Advisory Council Report. (See "Current Proposals Mix Several Elements.")

In addition, the benefit formula provides that benefits are higher for workers with higher lifetime earnings but less than proportionately so.¹⁶ This “progressive” formula redistributes income from high earners to low earners to help keep low earners out of poverty. At the same time, the formula attempts to maintain some degree of equity for higher earners by providing that benefits increase somewhat with earnings. The specific parameters of the formula implicitly reflect a particular balance between these adequacy and equity concerns.

Modifying the formula could include changing the parameters that determine the progressivity of the formula. Such changes could reduce benefits for high earners but leave low earners' benefits unchanged. However, this could raise equity concerns because high earners would get lower benefits relative to their earnings than they do now. Alternatively, parameter changes could reduce benefits across the board, which could raise concerns that persons with the lowest benefits might not get the retirement income they need.

In addition, initial benefits could be reduced by changing the adjustments for early or delayed retirement. Such changes should increase the incentive to postpone retirement and continue working.

Raising the Retirement Age

Raising the retirement age would reduce benefit costs and could involve increasing the normal retirement age (NRA), the early retirement age (ERA), or both. The appropriate age for retirement has arguably changed because life expectancy has increased and the health of the elderly has improved. However, these improvements have been enjoyed primarily by those with higher education and socioeconomic status.

Under current law, persons who retire before the NRA receive reduced benefits; those who retire after the NRA receive increased benefits. Therefore, raising the retirement age implicitly has the effect of reducing initial benefits for all retirees. For example, under current law, persons who retire at today's NRA of 65 would get the basic benefit amount, without adjustments for either early or delayed retirement. As the NRA increases to age 67, persons who still retire at age 65 will have their basic benefits reduced for early retirement. Those in the same age group who retire at

¹⁶Specifically, the “primary insurance amount” (PIA) is the full monthly benefit payable to retired workers at age 65 or to disabled workers when first entitled. For those entitled to benefits in 1997, the PIA equals (1) 90 percent of the first \$455 of average indexed monthly earnings (AIME), plus (2) 32 percent of the next \$2,286 of AIME, plus (3) 15 percent of AIME over \$2,741. The bend points in this formula (dollar amounts of AIME defining each bracket) are indexed to increases in average national earnings.

other ages would see larger reductions for early retirement or smaller increases for delayed retirement than they would under current law.

Raising the ERA as well as the NRA would eliminate retired worker benefits entirely until workers reach the new ERA. More than 50 percent of newly retired workers currently receive benefits at age 62, and more than two thirds retire before age 65. Therefore, the cost savings from increasing the ERA would be substantial. However, some workers who would have retired before age 65 would still qualify for Social Security under the Disability Insurance program.

Reforms relating to the retirement age could provide incentives to work longer, but their effects also depend to some degree on the labor market's response. Having people work longer would help with the demographic problem of the declining ratio of workers to retirees. Working longer could increase workers' Social Security and pension benefits and allow them to increase their savings rather than spend them. Still, it remains unclear whether workers will want to work longer, whether they will need to because of benefit reductions, and whether employers will provide attractive opportunities to continue working rather than incentives to retire early. In recent years, workers have been retiring earlier, not later, and not always by choice. Less than one sixth of men aged 65 and over are in the labor force today, compared with nearly half in 1950.

Reducing COLAs

Since 1975, Social Security benefits have been automatically increased to keep pace with inflation and maintain their purchasing power. However, some believe that the CPI, which is used to determine COLAs, overstates the true inflation rate. A recent report estimated that the CPI exceeds the true inflation rate by about 1 percentage point.¹⁷ If the CPI overstates inflation, then Social Security COLAs increase benefits too much. Moreover, COLAs are costly. Social Security currently pays about \$350 billion in benefits; therefore, each 1-percent COLA raises outlays \$3.5 billion. COLA increases and any errors in them are cumulative, with each year's adjustment compounding the previous years' adjustments. For the same reason, however, COLA reductions would have a compound effect on benefits. Many retirees rely on Social Security COLAs to help keep up with inflation because most pensions have no inflation adjustments or only partial ones.

Proposals to modify the COLA include the following: making technical adjustments to the CPI itself; limiting COLAs, for example, by using the CPI

¹⁷Advisory Commission to Study the Consumer Price Index, "Toward a More Accurate Measure of the Cost of Living," Final Report to the Senate Finance Committee, Dec. 1996.

minus 1 percentage point or capping the COLA at, say, 2.5 percent; delaying the COLA for a specified number of years or until cumulative inflation reaches, say, 5 percent since the last adjustment; eliminating the COLA; or limiting a full COLA to persons with relatively low benefits.

Means-Testing Benefits

Means-testing Social Security benefits would also reduce program costs and direct benefits to persons who need them most. It would reduce benefits for those with incomes above a certain threshold or from specified sources, such as other pensions. However, persons losing benefits would tend to be those who pay the highest Social Security taxes and already implicitly receive the lowest rates of return on their contributions. Means-testing would further reduce benefit equity for them and could diminish whatever political support they give to the system. Means-testing could raise perceptions of Social Security as a welfare program rather than a program that ensures a basic retirement income to persons who work and contribute to the system their entire working lives.

Means-testing could also be applied specifically to dependents' benefits.¹⁸ Social Security provides benefits for spouses and children of retired, disabled, and deceased workers. For example, eligible spouses currently receive a benefit based on half the worker's basic benefit, regardless of the worker's benefit amount.

Increasing Income Taxes on Social Security Benefits

In a sense, income taxes on Social Security benefits already provide a limited means test. Social Security benefits are subject to income taxes if current income exceeds \$25,000 for a single person or \$32,000 for a married couple. Also, taxes currently apply to only a portion of benefits, up to 85 percent of them, depending on adjusted gross income. Modifying these provisions further, by making 100 percent of benefits subject to income tax above certain income levels, for example, would have an effect similar to a means-tested benefit reduction.

Increasing Revenues From Social Security Payroll Taxes

The Social Security payroll tax provides about 90 percent of the system's revenue, and increasing the payroll tax rate is the most obvious way to increase revenues. However, for many people, the Social Security tax is already the largest tax they pay. According to SSA's intermediate actuarial assumptions, increasing the payroll tax rate from 12.4 to 14.6 percent for 1996 and subsequent years would have restored financial balance for the

¹⁸In 1995, about 43 million people were receiving Social Security benefits, of which 3.3 million were spouses, 5.5 million were widows or widowers, and 3.7 million were children. Half of children beneficiaries were children of deceased workers and more than a third were children of disabled workers. About 27 million of the beneficiaries were retired workers, and more than 4 million were disabled workers.

next 75 years.¹⁹ Increasing the payroll tax rate would cause all covered workers and their employers to pay more taxes, but workers would receive no increase in benefits from paying these additional taxes. Also, by reducing workers' disposable income, such tax increases would make it more difficult for some workers to save.

Enlarging the Social Security tax base would also increase payroll tax revenues. For example, the maximum earnings subject to the payroll tax are \$65,400 per year in 1997.²⁰ Increasing the earnings subject to the payroll tax would increase taxes for a relatively few high earners (about 6 percent of all workers). In addition, about 4 percent of the workforce remains uncovered, which mostly includes some state and local government employees and federal employees hired before 1984. Bringing new state and local workers into the Social Security system would expand the payroll tax base. However, expanding the tax base also increases future benefit payments because the newly covered earnings would be included in benefit computations.

Investing Trust Funds in the Stock Market

Investing some portion of the Social Security trust funds in the stock market rather than in government securities might increase system revenues but has potential drawbacks as well. Historically, stock investments have earned higher returns on the average than Treasury securities, but they also carry higher risks. Nevertheless, investing in stocks could increase program revenues without raising taxes. However, Social Security would no longer buy as many Treasury bonds, so Treasury would have to sell more in the private capital market.

As a whole, the federal government would be selling lower-yielding government bonds and buying higher-yielding private securities. In turn, such government activity could affect prices of stocks and their expected returns and interest rates. Also, as partial owners of a company, stockholders can vote on company policies, which raises the question of whether and how the government would exercise its voting privileges. While the funds could be invested in "passively managed" portfolios, political pressures could also lead the government to select or omit particular stocks for investment.

¹⁹However, each year's actuarial valuation covers a new 75-year period. Therefore, long-term actuarial balance can change from year to year.

²⁰The maximum earnings subject to Social Security payroll taxes is updated automatically each year in proportion to increases in the average annual wage.

Program Restructuring Serves Other Objectives as Well as Long-Term Balance

A variety of proposals would address Social Security's long-term funding problems by significantly restructuring the program, usually by privatizing at least a portion of it.²¹ Such proposals still essentially achieve financial balance by, in effect, raising revenues and reducing costs, but they do so in ways that pursue other objectives as well. Some would reduce the role of Social Security and the federal government in providing retirement income and give individuals greater responsibility and control over their own retirement. Some proposals focus on trying to increase national saving and funding future Social Security benefits in advance.

Generally, privatization proposals focus on setting up individual retirement savings accounts and requiring workers to contribute to them. The accounts usually replace a portion of Social Security, whose benefits would be reduced to compensate for revenues diverted to the savings accounts. Some combine new mandatory saving and Social Security benefit cuts, hoping to produce a potential net gain in retirement income. The mandated savings deposits and revised Social Security taxes combined would be greater than current Social Security taxes, in most cases.

Virtually all proposals addressing long-term financing issues would increase the proportion of retirement assets invested in the stock market or in other higher-risk, higher-return investments. The common objective is to finance a smaller share of retirement costs with worker contributions and more of the costs with investment returns.

The federal government's Thrift Savings Plan (TSP) for federal workers exemplifies how individually held accounts could be invested in the private sector with a limited government role. Under TSP, vested federal workers own their savings accounts and choose how to invest them in a range of passively managed funds, which include funds invested in stocks, corporate bonds, and government bonds. The government administers these funds through contractors and delegates proxy voting to them.²²

In the case of individually managed savings accounts, the risk of economic and market performance would be shifted to the worker. Individuals with

²¹Chile is often cited as an example of how privatization can work. Other countries also have planned or are planning to privatize their social security systems. However, their macroeconomic situations and political institutions often differ substantially from ours. For example, Chile is a much less developed economy than the United States, and when it privatized, it had limited capital markets and a budget surplus.

²²However, the size of such funds under various reform proposals would be far greater than under TSP and, thus, the voting issue would be magnified.

identical earning histories and retirement contributions could have notably different retirement incomes because of market fluctuations or individual investment choices. Some observers have expressed concern that many workers lack the knowledge necessary to make the best investment decisions. Many workers, especially women, invest too large a portion of their savings in relatively safe, fixed-income securities that earn a relatively low return and shy away from more “risky” equity investments that generally earn a higher average return. Proponents of privatization respond that investor education programs can teach workers how to manage their investment portfolios better. Limited research indicates that investor education is effective at increasing both workers’ retirement contributions and their investment returns. Finally, care must be taken to ensure that retirement savings would last until the retiree dies. Some proposals would require retirees to purchase a lifetime annuity with their retirement savings.

To the extent that privatization requires workers to increase their retirement saving, it could increase national saving. However, workers might reduce other saving either because they would have less disposable income from which to save or because they would, in effect, let the new retirement accounts substitute for their other saving. In cases in which privatization largely involves redirecting the Social Security trust funds’ balances into the stock market, whether government directs the investment or not, national saving would probably not increase significantly. Any increase in private sector investment could be offset, at least temporarily, by Treasury’s need to borrow money from the private sector to replace the funds it currently borrows from the trust funds.

Some of the privatization proposals raise the issue of how to make the transition to a new system. Currently, each year’s Social Security taxes are used for the most part to pay for that year’s benefits. Financing retirement through individually owned savings accounts requires “advance funding,” or saving this year’s contributions to provide future retirement income. Social Security would still have to have revenues to pay benefits that retirees and current workers have already earned. The revenues needed to fund both current and future liabilities would clearly be higher than those currently collected.

Privatization would also have a significant effect on the distribution of retirement income between high and low earners, although advocates claim that all would still be better off. As described above, the Social Security benefit formula redistributes income from high to low earners

and tries to balance the program's goals of providing equitable benefits while also meeting basic income needs. To the extent that privatization involves workers' contributing to their own retirement saving, their contributions are not available for redistribution. Some privatization proposals retain some degree of Social Security coverage or at least a means-tested safety net and therefore permit some redistribution to continue. In effect, such proposals separate the program's equity and adequacy goals.

Privatization proposals also tend to separate retirement benefits from Social Security's survivors' and disability benefits. In the cases of death or disability before retirement, individual savings may not have been building long enough to sufficiently replace lost income. Some privatization proposals, therefore, leave these social insurance programs largely as they are now. In the case of death after retirement, the surviving spouse and dependents may still depend on financial support from the retirement savings of the deceased. Therefore, some privatization proposals would require retired workers to purchase a joint and survivor annuity with their retirement savings or obtain spousal consent for the choice of a single life annuity. Joint and survivor annuities provide lower annual benefits but continue to pay benefits to the surviving spouses.

Current Proposals Mix Several Elements

The 1994-96 Advisory Council on Social Security recently issued a report in which its members offered three alternative reform proposals. While the council could not achieve majority support in favor of any one proposal, it did appear to reach agreement on certain points. Some individual components appeared in more than one of the three proposals:

- extending mandatory coverage to all state and local government workers hired after 1997;
- assume that revisions to the CPI, which were announced by the Bureau of Labor Statistics in March 1996, will lower the COLAs for future benefits by 0.21 percentage points;
- increase the number of years of earnings used in computing benefits from 35 to 38;
- subject benefits to income taxes to the extent that workers' benefits exceed their contributions and deposit the proceeds in the Social Security trust funds;
- accelerate the increase in the retirement age, so that the NRA will reach 67 for persons born in 1949 instead of 1960 and increase it after 2011 according to increases in longevity.

According to the National Academy of Social Insurance, these five measures combined would eliminate more than two thirds of Social Security's long-term financial deficit and postpone the exhaustion of the trust funds from 2030 to 2052.²³

Of the three comprehensive reform proposals, the one called the "maintain benefits" plan, generally associated with former Social Security Commissioner Robert Ball, would make the fewest changes to the current system. The Ball proposal would make all the changes above except for increasing the retirement age. In addition, it calls for studying the possibility of investing 40 percent of the trust funds in the stock market by selecting a portfolio that would track some broad market index such as the Wilshire 5000. The investments would be passively managed by an independent board. In addition to these and other changes, the Ball proposal would achieve long-term balance by increasing Social Security taxes in 2045 by 1.6 percentage points (0.8 percentage points each for employers and employees.)

A second proposal, called the "individual account" plan and generally associated with Council Chairman Edward Gramlich, would make all five of the changes above. In addition, the Gramlich proposal would gradually reduce benefits by modifying the benefit formula so that eventually all benefits would be financed by the current Social Security tax rate. After completely phasing in this change, benefits would be 17-percent lower for average earners, with larger reductions for high earners and smaller ones for low earners. Combined with raising the NRA, the average earner's benefits would ultimately decline about 30 percent. To offset these benefit reductions, the Gramlich proposal would add a mandatory individual savings account financed by new contributions from workers of 1.6 percent of their covered earnings, starting in 1998. Workers would choose among alternative investment options administered by a government board, similar to the administration of the TSP. At retirement, workers would be required to purchase a lifetime annuity with the money in these accounts.

The third proposal, called the "personal security account" plan and generally associated with benefits consultant Sylvester Schieber and economist Carolyn Weaver, would make the most dramatic changes to Social Security. The Schieber-Weaver proposal would extend coverage,

²³National Academy of Social Insurance, "Advisory Council on Social Security Plans," Social Insurance Update, Vol. 1, no. 3 (December 1996).

assume cost reductions from corrections to the CPI, and accelerate the increase in the retirement age. In addition, it would transform Social Security into a two-tier system. In the first tier, a basic flat benefit amount adjusted for years with covered earnings would be paid to all retirees. The amount would equal about two thirds the current poverty level for a single elderly person, or \$410 per month in 1996. The second tier would be a personal security account financed by shifting 5 percentage points of the existing employee tax into those accounts. Workers could invest these funds in a wide range of instruments but could not withdraw them before retirement. At the ERA, they could use the funds freely. The transition to the new system would require new taxes equaling 1.52 percent of covered payroll, starting in 1998 and lasting 72 years. Not insignificantly, it would also require additional government borrowing of nearly \$2 trillion in 1995 dollars during the first 40 years of the transition.

Social Security Trust Funds and the Federal Deficit

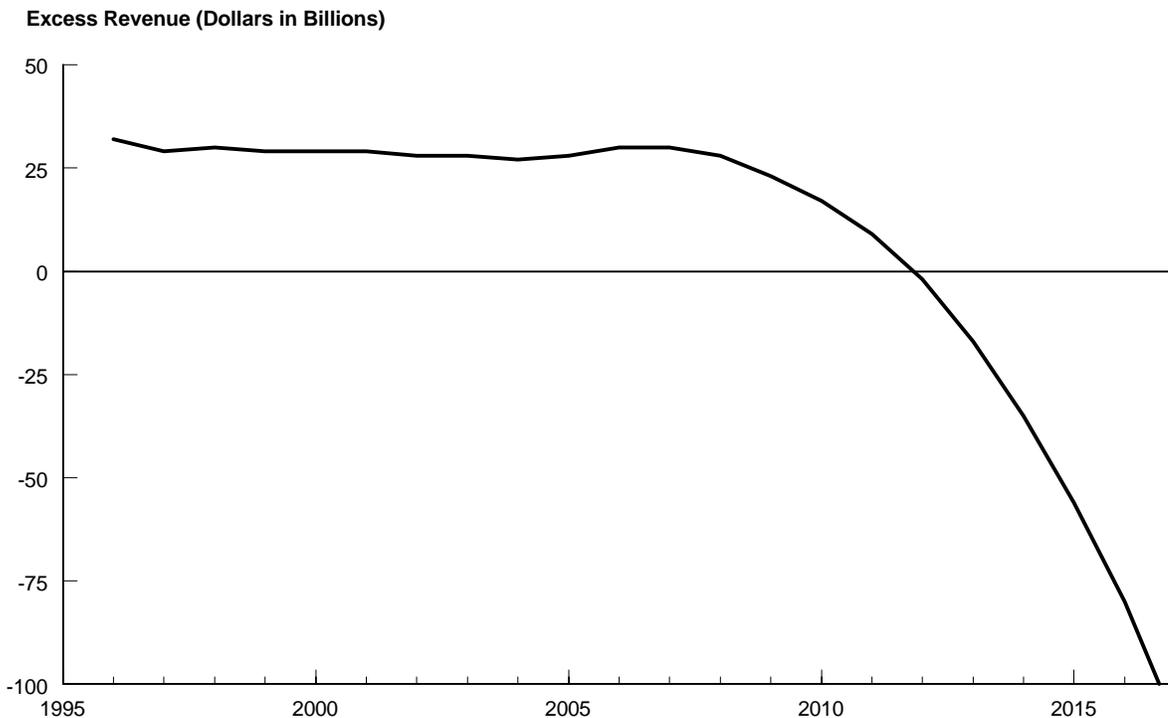
As a result of previous financing reforms, Social Security collects more in revenues than it pays out in benefits each year and builds up substantial trust fund reserves. This annual excess of revenues over expenditures lowers the total federal deficit. However, tapping these reserves in the future to help pay benefits would pose a substantial challenge for the overall federal budget.

The Social Security trust funds are by law invested in federal government securities and effectively lend money to Treasury. By investing in Treasury securities, Social Security reduces the amount that the federal government must borrow in the private financial markets. Until 2009, Social Security is expected to collect roughly \$30 billion more in cash each year than is needed to pay benefits. In addition, the trust funds' interest earnings were nearly \$40 billion last year and will grow as the reserves build up. Treasury credits this interest by issuing more securities. If Treasury had to replace borrowing from the trust funds with borrowing in the private market, it would have to pay this interest in cash. This cash could be borrowed by selling bonds in the private capital market, but such interest payments would further add to the overall federal deficit.

Social Security's excess cash revenues are expected to start falling rapidly in 2009 and to disappear in 2012, under the trustees' 1996 intermediate actuarial assumptions. (See fig. 3.1.) Expenditures will then exceed cash revenues, and the government's general fund will have to make up the difference, in effect repaying Social Security. This will increase the budget deficit, unless offset by revenue increases or spending reductions. In 2028,

this amount is expected to reach about \$183 billion in 1997 dollars. In that year, the budget deficit from Social Security alone would equal 1.4 percent of GDP, which is the same share of GDP as last year's deficit for the entire federal budget. The trust funds are expected to be depleted in 2029.

Figure 3.1: Social Security's Revenues Exceed Expenditures Now but Fall Short Later



Source: 1996 Annual Trustees' Report and unpublished SSA data.

Solving Social Security's long-term financing problem will not necessarily eliminate this budget challenge. Some Social Security reform proposals would diminish the trust fund build-up and spend-down. However, in any event, efforts to maintain a stable fiscal policy will depend to some extent on how this spend-down is addressed.

Private Pensions and Retirement Saving Can Help With Retirement Income Challenges

While Social Security provides a foundation for retirement income, increasing private pension coverage and individual retirement saving can contribute substantially toward meeting the income needs of the elderly and help increase national saving at the same time. To fulfill their potential as major retirement income sources, both pensions and savings must be secure and carefully managed.

The two basic types of pension plans are defined benefit and defined contribution plans. A defined benefit (DB) pension plan promises the worker a benefit based on a specific formula linked to the worker's earnings and years of employment. The employer, as the plan sponsor, is responsible for funding the promised benefit, investing and managing the funds, and bearing the investment risk. In terms of coverage, DB pensions were the predominant type of employer pension for many years. In 1975, three fourths of workers covered by a private pension had DB plans.

Under defined contribution (DC) plans, a percentage of pay is contributed to an account for each worker. While the employer generally makes the contribution, the increasingly popular 401(k) plans also allow contributions by workers. Retirement income from DC plans depends on how much money is deposited and how much the invested funds earn. In DC plans, the worker bears the investment risk and often controls how the funds are invested. Because nearly all DC plan benefits are taken immediately as a lump sum, DC pensions are considered to be more portable than DB plans, which frequently pay a life annuity at retirement.

Federal Policies Promote Pension Coverage and Benefit Security

The federal government has an interest in promoting pension coverage to ensure greater retirement income security and to help increase national saving. Also, the government has assumed the role of helping protect workers' legal rights to pension benefits. The Internal Revenue Code and ERISA define the government's role, and the Department of Labor (DOL), the Internal Revenue Service (IRS), and PBGC carry out the laws.

The Internal Revenue Code provides preferential income tax treatment for pension contributions and for the capital gains on the funds. These tax preferences have the greatest relevance to employees rather than employers. For employers, all wages are tax deductible just as pension contributions are, but employees do benefit from the deferral of income tax on their pension benefits until they receive them. In particular, the extension of preferential tax treatment to employee contributions to 401(k) plans has resulted in the substantial growth of these plans. Even so,

the effect of these tax preferences depends significantly on the structure of income tax rates. Marginal tax rates on high and middle earners have dropped considerably since the 1970s. The tax rate on capital gains also affects these tax preferences because many DB and DC pension assets are invested in equities and other financial instruments that would otherwise be subject to the capital gains tax. Also, tax preferences for pensions result in substantial foregone federal revenues, and the Congress has an interest in limiting these losses and has at times attempted to target who benefits from them and how much. Therefore, changes in tax policy could have a significant effect on pension coverage.

To qualify for preferential tax treatment, pension plans must adhere to various standards. For example, in 1942, the Congress enacted “nondiscrimination” provisions to ensure that pension plans did not receive favorable tax treatment if a disproportionate share of the benefits accrued to company officers or other highly paid individuals.

In 1974, the Congress enacted ERISA to make pension promises more explicit and workers’ benefits more secure. Among other things, ERISA requires that private DB plan sponsors make contributions according to actuarial standards to help ensure adequate funding. In addition, ERISA requires such sponsors to pay pension insurance premiums to PBGC, which assumes the liability for terminated DB plans and pays the retirement benefits, subject to certain limits. ERISA also requires that plan investments be diversified and that plan fiduciaries adhere to prescribed standards of conduct.

More Will Receive Pensions Although Coverage Has Not Grown Recently

Pension coverage for workers in the private sector increased from 15 percent to 45 percent between 1940 and 1970. This expansion resulted from a variety of factors, including tax preferences, healthy economic expansion, and the growth of labor unions and also from wage and price controls during the 1940s and 1950s. Despite wage controls, employers were able to meet union requests for increased compensation by offering pensions and other employee benefits. However, since 1970, the coverage rate has changed very little; it stood at 47 percent in 1993.

Nevertheless, in spite of stagnant pension coverage, more workers covered under pension plans and their spouses will eventually receive pensions. ERISA established vesting rules in 1974 and set a 10-year minimum before employees could vest—that is, earn a legal right to their pension benefits. In 1986, the rule was liberalized, allowing either a 5-year

“cliff” or a graded vesting schedule under which participants are 20 percent vested after 3 years and receive an additional 20 percent each subsequent year until they are fully vested after 7 years. As a result, more covered employees will meet the vesting requirement, although benefit levels will reflect the shorter job tenures of the employees affected.

In addition, more women are working, so more retired couples will have pension income. Also, a larger share of widowed and divorced retirees will receive pension income from their spouse’s employers because of spousal notification laws enacted in 1984.²⁴

Economic Considerations and Regulation Affect Pension Coverage

Employers offer pensions because they help attract and retain valuable employees, encourage older workers to retire, and give workers an additional incentive to perform well and promote the ongoing success of the employer. Workers accept pension arrangements in place of higher wages and, in fact, unions often seek them because workers benefit from the tax advantages and, with DB pensions, from having employers bear the risk of long-term commitments (unless and until benefits are distributed as a lump sum).

However, some factors might make further increases in worker coverage unlikely. About 60 percent of all older (aged 40 to 60) workers are already covered. Moreover, employers are less likely to offer pensions if their workforce tends to be less educated, lower-skilled, or younger or exhibits high turnover. Only 34 percent of those in their twenties are covered by pensions. Also, smaller employers are less likely to offer pensions. For example, only 28 percent of workers at firms with 25-49 employees are covered, while at firms employing more than 1,000, 67 percent are covered. Finally, about 9 percent of the workforce is self-employed, and these workers must, of course, provide for their own retirement income.

Structural changes in the economy also influence employers’ decisions to provide pensions. In 1945, 35 percent of the workforce, both private and public, was unionized, compared with 16 percent in 1990, and nearly 80 percent of union workers have pension coverage compared with about 40 percent of nonunion workers. In addition, the rising cost and demand

²⁴The 1984 Retirement Equity Act made the joint-and-survivor benefit the default option for married workers retiring on a pension. Under the joint-and-survivor option, a surviving spouse will continue to receive pension benefits once the pension beneficiary dies. To waive this option, both the retiring worker and his or her spouse must sign a waiver form. Prior to this law, waivers from spouses were not required, and few retiring workers selected the joint-and-survivor option. As a result, many spouses were left without pension benefits when the retiree died first.

for health care has strained the resources that employers have available for other employee benefits.

Since ERISA was enacted, legislative and regulatory activity regarding pensions has increased. This activity provided improved benefit security for workers but has affected the structure of pensions. Some of the changes have focused on limiting the federal revenues foregone because of the favorable tax code provisions. However, federal regulations, especially when they change frequently, tend to increase the cost of pensions and reduce employers' incentive to sponsor pension plans.²⁵

Pension Simplification Is a Focus of Recent Legislation

In response to concerns about regulatory burdens on employer pension plans, recent federal initiatives have focused on pension simplification. These efforts seek to encourage expanded coverage by reducing the regulatory requirements for small employers to start pensions. However, this regulatory relief is usually accompanied by a required employer contribution for all employees that might not be attractive to the small employer. Past pension expansion efforts along this line, such as simplified employee pensions (SEP), have not been notably successful in raising pension plan sponsorship rates.²⁶

The Small Business Job Protection Act of 1996, created a new "savings incentive match plan for employees" (SIMPLE) for firms with 100 or fewer workers that do not already offer a pension plan. The plan could be based on IRA or 401(k) arrangements and, sponsors would be exempt from certain "nondiscrimination" rules or, under certain conditions, other rules that might otherwise deter plan sponsorship. An employee could contribute up to \$6,000 yearly, and the employer would have to meet a matching requirement.²⁷

DC Pension Coverage Has Grown

Although pension coverage on current jobs has been generally stable overall, the number of workers participating in DC plans has grown steadily

²⁵Committee for Economic Development, Who Will Pay For Your Retirement?: The Looming Crisis (New York: 1995).

²⁶See Private Pensions: Changes Can Produce a Modest Increase in Use of Simplified Employee Pensions (GAO/HRD-92-119, July 1, 1992).

²⁷For more detailed information on the provisions in the bill see James R. Storey, Pension Proposals for Simplification and Increased Access (Washington, D.C.: Congressional Research Service, July 16, 1996). For another discussion on related proposals advanced by the Clinton administration, see James R. Storey and Ray Schmitt, Pension Reform: President Clinton's Proposed Retirement Savings and Security Act (Washington, D.C.: Congressional Research Service, July 10, 1996).

over the past 20 years. In 1975, 27 percent of pension plan participants had DC plans; by 1990, 50 percent had them.²⁸ With this trend, more of the risk and responsibility for providing pension income is shifting from the employer to the employee. Recent data and analysis suggest that, rather than representing replacement of DB plans by DC plans, this trend mainly reflects that new or additional pension benefits are often offered as DC plans. Many larger employers supplement their DB plans with DC plans.²⁹

In addition, the relatively faster growth of employment at smaller firms may help explain the trend toward DC pensions, which are easier for smaller employers to administer. Between 1980 and 1993, the number of employees in firms with fewer than 100 employees grew 30 percent, twice as fast as for firms with 500 or more employees. In 1993, small firms accounted for 56 percent of all employees. About 25 percent of full-time employees in small firms participate in DC plans, compared with 12 percent participating in DB plans.

The 401(k) plan is the fastest growing type of DC pension that allows employees to make tax-deferred contributions that may be augmented by the employer. The growth of these accounts has contributed substantially to the DC trend. Between 1984 and 1990, 401(k) plans' share of all private plans grew from 3 to 14 percent, and their share of all active pension plan participants grew from 19 to 46 percent.³⁰ This growth appears to be continuing.

Efforts to Increase Personal Retirement Saving Have Not Been Successful

Personal savings outside pension arrangements can contribute substantially to retirement income. However, saving patterns vary considerably among families. While most families say they recognize the need to save for retirement, many do not save in any systematic way. As with pension coverage, government efforts to encourage more personal retirement saving seem to have had only marginal effects.

According to our analysis of the University of Michigan's Health and Retirement Survey, the average net worth of families whose heads are nearing retirement age (from 55 to 61 years of age) is almost \$250,000. However, the distribution of wealth is uneven, and many families near

²⁸Percentages are not adjusted for double counting of individuals participating in more than one plan. For a more recent analysis of defined contribution plans see *Private Pensions: Most Employers That Offer Pensions Use Defined Contribution Plans* (GAO/GGD-96-181, Oct. 3, 1996).

²⁹Employee Benefits Research Institute, "Pension Evolution in a Changing Economy," Special Report and Issue Brief No. 141, Washington, D.C., Sept. 1993.

³⁰401(k) participants may participate in one or more additional plans.

retirement have relatively few retirement savings. According to our analysis, over half of these families have less than \$100,000 in assets, and 25 percent have less than \$25,000 in assets. Over one quarter of families near retirement in this survey do not own their own home, almost 60 percent have no IRA, over 70 percent do not own stocks, 92 percent do not own bonds, and half have less than \$5,000 in bank accounts.

Tax policy affects how people save for retirement, but its effect on the overall level of personal saving is less clear. Since the 1970s, federal laws have granted favorable tax treatment to IRAs and to the closely related 401(k) pension plans. In 1981, most constraints on IRAs were lifted so that nearly all workers and their spouses could participate, making this form of tax-deferred saving very popular. After 1986, tax policy limited the group of workers who could make tax-deductible IRA contributions. Total contributions fell by more than 60 percent, and the percentage of all tax returns claiming an IRA deduction fell from 16 percent in 1985 to 6 percent in 1988. Recent polling evidence suggests that people would save more in IRAs if the tax benefits were increased. The 401(k) plan has many of the same tax advantages as IRAs and is now the fastest growing type of pension plan.

Preferential tax treatment for IRAs and 401(k) accounts seems to encourage saving in these vehicles, but they may not necessarily represent totally new saving. Some contributions may merely have been shifted from other forms of saving. Between 1970 and 1994, personal saving rates declined from roughly 8 to 4 percent of disposable personal income, even with these retirement saving incentives. Also, according to available data, most persons responding to these tax preferences are middle- to upper-income, not lower-income, who receive very little income from retirement savings. Low-income families may find it especially difficult to save, and most public assistance programs penalize private saving by requiring low levels of financial assets in order to qualify.

Will Pensions and Savings Be There for Retirement?

To fulfill their potential as retirement income sources, pension assets and savings must be preserved and carefully managed. ERISA sets out requirements regarding how pension assets must be managed, invested, and preserved for retirement. While tax rules discourage using pension assets for nonretirement purposes, they do not prohibit such use entirely. Also, many pensions allow workers to take a lump sum at retirement rather than receive an annuity. If they elect to take a lump sum, retirees

must then carefully manage these assets along with their other savings to make them last throughout their retirement.

Protecting DB Plan Assets

PBGC insures and guarantees DB pension benefits, and IRS monitors plan funding status. Funding requirements aim not only to protect workers' pensions but also to limit PBGC's risk of assuming financial responsibility for unfunded benefits when employers go out of business. Premiums for pension guaranty insurance are set so that they increase as the extent to which the plan is underfunded increases. Underfunded plans may also be required to make contributions that gradually reduce the plan's unfunded liability. Recently, the Retirement Protection Act of 1994 revised rules relating to pension plan underfunding. Along with the healthy investment returns that pension funds have enjoyed, such reforms have substantially improved funding levels and have reduced the financial risk to the pension sponsors that pay the PBGC insurance premiums. Under current law, PBGC may borrow up to \$100 million from Treasury, but the federal government has no legal obligation to back up PBGC otherwise.

For well-funded plans, boosted by the strong stock market performance of the 1980s and 1990s, the issue arises of how to deal with overfunding. Since firms own the pension assets, they sometimes want to take some of the excess assets back and use them elsewhere. The courts have upheld plan sponsors' right to "revert" assets, and the practice may be consistent with prudent plan funding. Still, the Congress has been concerned that such reversion may threaten benefit security if the sponsors or their pension funds do poorly in the future. The Congress imposed substantial penalties in response to a wave of reversions in the 1980s, largely stopping the practice. As recently as 1995, proposals were offered to loosen these restrictions.

Investing and Preserving DC Plan Assets

With DC pensions, as well as with individual retirement saving, workers generally have responsibility for directing how their assets are invested. Some invest conservatively and earn low returns even though they still have many years before retirement and could arguably bear the risks associated with higher-return investments. To help expand workers' investment choices, DOL recently issued an interpretive bulletin regarding the 404(c) rules to clarify the kinds of investment information firms can give their workers without being professionally liable for giving investment advice.

Workers also diminish their DC pension savings when they use the funds for nonretirement purposes. Most plans allow participants to borrow from their accounts for nonretirement expenditures such as purchasing a home or paying educational or emergency expenses. Overall, more than 75 percent of workers with DC pensions are able to borrow from their retirement accounts. Of these workers, almost 8 percent have outstanding loans, with an average balance of \$3,000. A recent Clinton administration proposal would allow early, penalty-free IRA withdrawals for selected expenses. This added liquidity may actually encourage more pension saving. Still, if workers do borrow, they may reduce the savings available for retirement.

At retirement, IRA and DC pensions do not have to be taken in the form of an annuity and are generally taken as a lump-sum amount. Moreover, about 33 percent of DB plan sponsors, who covered more than half of all participants, provided a lump-sum option for retiring workers. Annuities help insure retirees against living longer than their retirement funds would last, but retirees pay insurers for assuming this risk. In contrast, without an annuity, retirees assume much of the risk for their longevity as well as responsibility for their wise use of the funds. However, since the federal and state governments provide public assistance benefits for the low-income elderly, they also assume some of this risk.

Concluding Observations

Dramatic growth in our nation's elderly population raises issues not just for the future of retirement income but also for the federal budget and for the economy as a whole. The elderly will consume an increasing share of the nation's output, and unless retirement or work patterns change, relatively fewer workers will be supporting more retirees. Our analysis leads us to five observations about the future direction of federal retirement income policy.

First, if the dominant purpose in examining Social Security is to restore long-term financial balance to the Social Security system, then some combination of traditional adjustments —revenue increases or benefit reductions —could be sufficient. However, some observers believe that the structure of this program should be reevaluated in light of the economic, political, and demographic changes of the past 60 years. Even though Social Security has become the most important single source of retirement income for many people, many believe that now is an appropriate time to assess whether the current structure of benefits best serves today's retirement needs.

Second, giving people greater responsibility for their retirement income and greater opportunity to invest their savings to earn potentially higher rates of return might raise the general welfare of the nation's elderly retirees. But such potential gains must be weighed against the potential problems associated with having individuals bear much more of the risk in saving for retirement. Also, if the Social Security program is to continue to play an important role in ensuring that the less-well-off have a basic retirement income, then care must be taken to ensure that changes in the Social Security program do not exacerbate the condition of particular groups of elderly poor. Unmarried women are currently much more likely to have incomes below the poverty line than other beneficiaries. Changes such as increasing the number of years used in computing benefits would disproportionately affect women because they more often already have several years of zero earnings included in the benefit calculation. Such distributional effects will have to be considered in any reform proposal.

Third, while Social Security's long-term financing problem and the federal budget deficit are different issues, the practice of using the Social Security trust funds' surpluses to partially offset the deficit elsewhere in government has substantially intertwined the two issues. The program's annual cash surplus is projected to start falling by 2009 and to disappear entirely in 2012, under Social Security's intermediate assumptions. As payments to beneficiaries begin to exceed cash receipts, Social Security

will have to redeem the Treasury certificates it now holds. Redemptions will reach nearly \$200 billion annually in 2028 (in 1997 dollars) and will place significant strains on the federal budget. Moreover, some of the proposals to privatize Social Security involve heavy additional federal borrowing to finance the transition from a pay-as-you-go to a partially or fully funded system. All proposals will have to be examined not only for their effect on Social Security but also for their overall budgetary consequences.

Fourth, to respond to the nation's retirement income challenges effectively, we must also examine pensions and private savings and the potential effect of Social Security reform proposals on them. For example, raising Social Security taxes could make it more difficult for people to save for their retirement or to contribute to their pensions. Proposals to solve Social Security's long-term financial problem will have to take into account the effect on achieving our goals of encouraging greater employee participation in pensions and increased rates of national saving.

Finally, some of the Social Security privatization proposals focus on increasing the national rate of saving. If successful, these changes could help raise our standard of living and help mitigate the strain from dealing with Social Security's financing problem. Increased national saving could lead to higher rates of economic growth, which, in turn, would make it easier to meet the financial challenges posed by the shortfalls in Social Security. However, raising the national saving rate may prove to be difficult. The proposals that aim to increase national saving through creating individual retirement savings accounts cannot guarantee that these savings will not simply substitute for other forms of saving. In addition, some of the proposed changes to the nation's retirement system could have significant effects on the nation's equity and bond markets, and this will have to be evaluated before such changes are adopted.

Ensuring that Americans have enough retirement income in the twenty-first century to meet their needs will require that the nation and the Congress make some difficult choices. Social Security has been an effective agent for ensuring a reliable source of income in retirement and greatly reducing poverty among the elderly. The effect of changes to the system on other retirement income sources and their effects on various groups within the aged population should be well understood before decisions are made. Further, the interplay of budget and saving effects will have to be carefully considered before any reform proposal is adopted.

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