CRS Report for Congress

Social Security: "Transition Costs"

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Summary

The chief actuary of the Social Security Administration (SSA) forecasts that under current law, the Social Security Trust Funds will be depleted in 2042.[1] Many Members of Congress have expressed concern that restoring the program to long-term fiscal balance will impose burdens on future generations by requiring them to pay higher taxes, accept benefit cuts, or undertake substantial government borrowing to pay the full benefits promised under current law.

Some policy analysts have suggested that pre-funding Social Security benefits through individual accounts (IAs) could improve the solvency of the current system, thus reducing or eliminating the need for higher taxes, lower benefits, or increased borrowing. However, there is general agreement among economists that any transition to a pre-funded system results in additional costs, so-called "transition costs," in the short-run. Most Social Security tax revenues are immediately used to fund payments to current Social Security beneficiaries. Therefore, a system of individual accounts that is funded by diverting part of the current Social Security tax into individual accounts will worsen the fiscal imbalance of Social Security and the overall budget, at least temporarily. Over a 75-year period, individual accounts could improve the unfunded liability of the Social Security system by $0.8 trillion or worsen it by up to $4.6 trillion, depending on how the account is structured. However, beyond the 75-year actuarial period, the benefit offset feature of most individual accounts would ultimately cover these transition costs and improve the long-term solvency of the Social Security system, leading some to refer to "transition costs" as "transition investments." This report will be updated as legislative developments occur.

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[1] The analysis in this report presents the effect on solvency of the IA component of reform proposals int the 108th Congress (see **Table 1**). Since the SSA's Office of the Chief Actuary has not published actuarial memoranda on any of the Social Security reform proposals introduced in the 110th Congress, we are unable to update Table 1 of this report accordingly. As the analysis in Table 1 is based on the 2003 and 2004 Trustees Report assumptions, we use these assumptions throughout the report.

Since its inception in 1935, financing for the Old-Age, Survivors and Disability Insurance (OASDI) program, more commonly known as Social Security, has been based primarily on the concept of "pay-as-you-go" or PAYGO.[2] Under the PAYGO system the Social Security contributions of *today's workers* fund the Social Security retirement, survivor or disabled worker benefits of *today's beneficiaries*. Congress selected this method of financing because of the great number of older Americans who were living in poverty at the time of the Great Depression. Congress decided that this generation of older persons should receive Social Security benefits, despite not having contributed to the system, because of the severity of the economic situation at the time and because most of them would not have been able to find employment and then contribute to the system long enough to be eligible for benefits.

As a result of the PAYGO system, most of Social Security's annual revenues are immediately paid out as benefits to current retirees, survivors or disabled workers. Social Security's annual revenues come from three main sources: the payroll tax on earnings (the FICA (Federal Insurance Contributions Act) tax and the SECA (Self-Employment Contributions Act) tax); interest earned on the Treasury bonds held by the Trust Funds; and, revenues from the taxation of Social Security benefits. In 2003, Social Security revenues equaled $632 billion and Social Security outlays totaled $479 billion, or 75% of revenues. Thus, in 2003, Social Security had a surplus of $153 billion, or 25% of revenues. These Social Security surplus dollars are not held by the Social Security Trust Funds. Rather, according to law, surplus receipts are credited to the Social Security Trust Funds in the form of special-issue non-marketable Treasury bonds. The actual surplus dollars are held by the U.S. Treasury where they become part of the general revenue pool and can be used to increase spending, reduce taxes, or reduce the government debt. Unless these dollars are used to reduce government debt, they are not really being 'saved' to pay for future Social Security benefits. In recent years, the Social Security surpluses have been used to offset increased spending or reduced taxes since the rest of the government's budget has been in deficit. Many economists have suggested that switching from a PAYGO system to a fully 'pre-funded' system would increase the government's ability to pay future benefits because payroll taxes contributed to Social Security would increase savings instead of being spent by the government.

What Are "Transition Costs"?

Shifting from a PAYGO system to a pre-funded system creates transition costs. Under a pre-funded system, the dollars that are contributed by *today's* workers are used to pay benefits for *today's* workers when they retire. Currently, today's workers' contributions are being used to pay benefits to yesterday's workers. Thus, in order to transition from a PAYGO to a pre-funded system, additional dollars must be found to continue payment of benefits to yesterday's workers. Most of the proposals that were introduced in the 108th Congress would use a system of individual accounts to accomplish

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[2] Social Security is no longer a purely PAYGO system. Under a purely PAYGO system, the annual taxes taken in from current workers and employers approximately equal the annual benefits paid out. However, in the 1983 Social Security Amendments, the Social Security payroll tax was increased in order to build a Social Security surplus, which was intended to improve the ability of the program to pay benefits in the future, particularly to the "baby boom" generation. This partial build up of reserves is referred to as "partially advance funding."

this pre-funding.[3] Any use of individual accounts to pre-fund Social Security benefits will necessarily impose additional costs, at least temporarily, because the nation will be paying for the Social Security benefits of current retirees and making contributions to current workers' individual accounts.[4]

Many Social Security reform proposals that include some type of individual account (IA) would re-direct part of the current-law payroll tax into the individual accounts and are thus known as "carve-out" accounts. This diversion of revenues from Social Security would reduce the revenue available to pay annual benefits and would create an *additional* funding gap between current-law revenues and current-law obligations. This additional cost is called a "transition cost" because it arises as a result of a transition to a system of individual accounts. To the extent that the moneys diverted to the IAs are smaller than the annual Social Security surplus in any given year, the carve-out will not affect the annual payment of benefits, but it would affect the annual revenue surplus, and thus the accumulation of Trust Fund surpluses. Reducing the Trust Fund surplus, absent other changes to the program, would hasten the date of Social Security insolvency. If the funds carved-out of Social Security taxes exceed the annual Social Security revenue surplus, it would hasten the date of insolvency further, because not only would the Trust Funds stop accumulating additional surpluses, but Trust Fund bonds would have to be redeemed to cover benefit payments to current recipients. In order to offset the revenue lost to the Social Security Trust Funds by carving out part of the Social Security tax and directing it into individual accounts, additional revenues would have to be raised either through increased taxes, reductions in government spending, or increased government borrowing.

Transition costs are not unique to individual accounts funded by a carve-out of Social Security taxes. There would also be transition costs to a system of "add-on" individual accounts, where all revenues dedicated to financing the current-law system continue to go for that purpose. As with the carve-out accounts, contributions to fund add-on accounts would have to be raised through increased taxes, reductions in government spending, or increased government borrowing.

Under both a carve-out system and an add-on system of IAs, additional revenues must be found to fund the accounts. Under a carve-out system, revenues are needed to continue to fund current-law benefits or reimburse the Trust Funds as a result of the

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[3] Pre-funding can be accomplished in a number of ways, not only through IAs. For example, if Social Security's Trust Funds were invested in the market directly, the surpluses would no longer be spent by the government and the government could redeem real assets to pay benefits in future years.

[4] Not all individual accounts would necessarily entail transition costs; however, these plans are financed on a PAYGO basis and do not achieve pre-funding of benefits. For example, in a "notional" account system such as the one in Sweden, the taxes paid in by today's workers are still paid out as benefits to current retirees. The difference between this IA system and the IA's being proposed in the U.S. is that, instead of actually taking contributions and investing them, the system uses a "virtual account" that records the contributions and tracks what the growth would be had they been invested. Then, when the individual retires, the IA is paid out *as if it had actually* been invested and earned interest. To offset the additional cost to the government of paying out possibly higher returns on the contributions, these plans often simultaneously reduce the traditional defined benefit at retirement. Because no new revenues are needed to fund the IAs, there are no up front transition costs.

revenues diverted to fund the IAs. Under an add-on system, there is no additional cost to the current Social Security system, but new revenues still would be needed to fund the IAs directly. In both cases, the revenues needed to fund the IAs represent an additional cost to the government as a whole, to individuals, the economy or all three, depending on the source of the contributions.

How Large are the "Transition Costs"?

The size of the transition costs will depend on the number of individuals who participate in the system and the amount contributed to the individual accounts. The greater the number of people participating, and the larger the contribution to the accounts, the greater the transition costs will be. In recent months, numerous press reports have cited transition costs of approximately $1 trillion-$2 trillion over a 10-year period. The President has not yet proposed a specific reform proposal, but some have suggested that the starting point for discussion would be "Model 2" of the 2001 Presidential Commission to Strengthen Social Security. Model 2 would permit workers to contribute an amount equal to 4% of their OASDI taxable earnings ($87,900 in 2004), up to $1,000 (indexed to wages after 2002) into an individual account.[5] The SSA's actuaries estimated in 2001 that the government would have to contribute $750 billion to $1.2 trillion over the first decade (in constant 2003 dollars) in order to fund the individual accounts, depending on whether 67% or 100% of eligible workers participated in the accounts, respectively.[6]

Some have argued that the $1 trillion-$2 trillion needed to transition to a system of individual accounts is small relative to the unfunded liability of the current system, cited in many newspaper articles as nearly $11 trillion.[7] However, this comparison is misleading since the $1 trillion-$2 trillion figure is an estimate of the transition costs *over 10 years*, while the nearly $11 trillion ($10.4 trillion) figure is an estimate based on funding the program *on an infinite horizon*. In order to obtain a valid comparison of the costs of making the transition to a system of individual accounts relative to the costs of maintaining the current system, the period upon which the comparison is made must be equal and the costs must be discounted over time. The Social Security actuaries have estimated that the present value of the current-law unfunded obligation is $3.7 trillion over the 75-year actuarial period that is the basis for all of their reform estimates.[8] The unfunded obligation is the difference between benefits which have been promised under current law and those that the system will be able to pay from current-law revenues. By comparison, over the same 75-year period, the net present value of the costs of the individual accounts proposed in Model 2, excluding any reductions to current-law benefits that are not a condition of participating in the individual account system, range from $1.5

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[5] Model 2 also included a number of changes to the Social Security defined benefit. For additional information on Model 2, please see CRS Report RS21095, *Social Security: Report of the President's Commission to Strengthen Social Security*, by Dawn Nuschler.

[6] SSA, Office of the Chief Actuary, Memorandum to Daniel Patrick Moynihan and Richard D. Parsons, Co-Chairs, President's Commission to Strengthen Social Security, Jan. 31, 2002.

[7] For example, see "Bush Rules Out Higher Payroll Tax for Social Security," *The Wall Street Journal*, Dec. 10, 2004.

[8] This estimate is of the OASDI program on an "open group basis," meaning that it takes into account all contributions and benefits paid to past, current, and future participants through 2078.

trillion to $2.2 trillion, depending on the level of participation in the accounts. Thus, the difference in costs is not the difference between $1 trillion-$2 trillion and $10.4 trillion, but the difference between $1.5 trillion-$2.2 trillion and $3.7 trillion.

Will Transition to an Individual Account System Result in Savings to Social Security?

Some observers have argued that the transition costs for a new system of individual accounts is small relative to the contributions these accounts could make to Social Security solvency in the very long-run.[9] Others argue that the individual accounts simply make the solvency situation worse.[10] One reason for these differing conclusions may be the time-frame used for the analysis. The SSA Actuaries selected a 75-year period for analysis of the program's solvency because it was felt that this was generally long enough to cover the anticipated retirement years of those currently in the work force. Others, including the President's Commission, have argued that the 75-year period does not take into account the projected current-law insolvency and the potential benefits of IAs in the 76th year and beyond. They propose using either a longer measurement period or an alternate accounting method such as an increasing ratio of the number of years of benefits that can be funded at the end of the actuarial period.

Most Social Security reform proposals would reduce Social Security benefits for those who participate in an individual account. In many cases, including Model 2, the increased value of the individual account itself does not reduce the unfunded liability of the current system. The savings come from additional reductions in the Social Security benefits that individuals will receive if they have participated in an IA, regardless of the type of investment and the actual rate of return earned. These reform proposals rely on these "benefit offsets" to pay for the up-front transition costs and reduce the costs of the Social Security system. However, as is evident from **Table 1**, over the 75-year period used by the Social Security actuaries to evaluate the system's solvency, many individual accounts would make the solvency problem worse. During this period, the benefit offsets are not large enough to cover the IA transition costs. Thus, it would be inaccurate to portray policymakers' choices as either the current-law unfunded liability or the IA transition cost. The cost of the transition to individual accounts is separate from — and in addition to — the system's current unfunded liability over this period. For example, with just the individual account component, the 75-year unfunded liability under Model 2 would increase from $3.7 trillion to $5.2 trillion or $6.0 trillion.

However, *beyond* the 75-year actuarial period, these "benefit offsets" could improve Social Security solvency. The main reason for the delay in realizing these savings is the time it would take for participants in the IA system to retire. For example, a 21-year old worker who enters the workforce in 2004 and contributes to an IA will not receive Social Security benefits until 2045 at the earliest. Thus, while the costs of funding the IA are immediate, the benefit offset designed to pay for funding the IA will not be realized until many years into the future. We are unable to provide an estimate of an IA's contribution

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[9] For example, see "Final Report of the President's Commission to Strengthen Social Security."

[10] For example, see "Would Borrowing $2 Trillion for Individual Accounts Eliminate $10 Trillion in Social Security Liabilities?," the Center on Budget and Policy Priorities, Dec. 13, 2004.

to solvency in the very long run because the official Social Security Administration actuarial analysis stops at 75 years. However, in most cases, by the 75th year of the IA the annual benefit offsets resulting from the IA are large and increasing. To the extent that the present value of future benefit reductions exceeds the present value of the up-front additional costs of the IAs over a longer time horizon, the accounts could contribute to reducing the unfunded liability of the current Social Security system.

Table 1. Effect on Solvency of Individual Account Component of Reform Proposals in the 108th Congress

Social Security Reform Proposals (President's Commission, Selected 108th Congress)	Net Present Value of Transition to IA over 75 Years (in constant 2003 dollars)
Unfunded liability of current-law system	$3.7 trillion
Change in current-law unfunded liability due to IA:	(+ represents an increase in liabilities and - represents a decrease in liabilities)
President's Commission to Strengthen Social Security — Model 2 (67% participation in IA)	+ $1.5 trillion
President's Commission to Strengthen Social Security — Model 2 (100% participation in IA)	+ $2.2 trillion
H.R. 75 (Representative Shaw)	- $0.8 trillion
H.R. 3821 (Representative Kolbe and Representative Stenholm)	+ $4.6 trillion
H.R. 3177 (Representative DeMint)	+ $1.0 trillion
S. 1878 (Senator Lindsey Graham)	+ $2.6 trillion
H.R. 4851 (Representative Paul Ryan)	+ $1.5 trillion

Source: Congressional Research Service calculations based on actuarial memoranda from the Social Security Administration's Office of the Chief Actuary available at [http://www.ssa.gov/OACT/solvency/index.html].

Notes: To isolate the net effects of the IA from the remainder of the reform proposal, the calculation counts as a transition cost the dollars put into the IA by the government and subtracts any dollars taken from the IA to help pay benefits over the 75-year actuarial period. This difference is the net transition cost. These costs are then calculated in present value terms in order to take account of the discounted future value of money. This present value calculation assumes that transfers to (costs) and from the IA (offsets) are made at the end of the year, and assumes a real interest rate of 3%, which is consistent with the intermediate assumptions of the 2003 and 2004 Trustees Reports. In the cases of reforms introduced in 2001 or 2002, the cost and savings streams were first converted from constant 2001 or 2002 dollars into constant 2003 dollars using the CPI-W.