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REFORM MODEL TWO OF THE PRESIDENT'S COMMISSION TO STRENGTHEN SOCIAL SECURITY: DISTRIBUTIONAL OUTCOMES UNDER DIFFERENT ECONOMIC AND BEHAVIORAL ASSUMPTIONS

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This analysis uses the Urban Institute's *DYNASIM3* model to examine the potential distributional impacts of Model 2 of the 2001 President's Commission to Strengthen Social Security. Model 2 would establish a new minimum benefit, provide enhanced widow(er) benefits, and replace the wage-indexing of the benefit formula with price indexing to help restore solvency to the system. Model 2 would also allow workers to divert four percentage points of their payroll taxes (up to $1,000 annually, indexed to wages) to a personal account. Basic Social Security benefits would be reduced by the annuitized value of these contributions, assuming they earn a two percent real rate of return annually.

Enacting the changes to Social Security's guaranteed benefits alone would reduce the projected average Social Security benefit in 2050 to 77 percent of that promised under current law, with the transition away from a wage-indexed benefit formula responsible for the benefit reductions. Total Model 2 benefits increase by 11 percentage points (to an average of 88 percent of promised current law benefits in 2050) when we include the annuitized benefits from personal accounts, projected using Social Security Office of the Chief Actuary (OCACT) personal account assumptions and assuming that all workers opt for an individual account. In other words, we expect personal accounts to achieve net investment returns that more than make up for the offset to the basic benefit (though this occurs in the context of sizable transfers from general revenues to finance the creation of the personal accounts). Nonetheless, benefits would fall below those promised under current law. Of course, comparing benefits under Model 2 to those promised under current law arguably sets the standard too high because the Social Security trust fund is out of long-term actuarial balance, and currently scheduled revenues will fund only about 71 percent of benefits in 2050.

We alter the OCACT assumptions regarding personal account participation, asset allocation, administrative costs, and investment returns in turn to provide a range of potential outcomes under Model 2. To alter participation and allocation assumptions, we construct models using recent data from the Survey of Consumer Finances (SCF), and to alter the remaining assumptions we rely on historical values and expert opinions from the literature. Our sensitivity analysis focuses on non-disabled beneficiaries age 62 to 69 in 2050, because they would be under the personal account system throughout their working lives.

We find that varying these assumptions can significantly change outcomes under Model 2. For instance, administrative costs 1.1 percentage points higher than OCACT assumes, along with voluntary account participation, would reduce the average expected annual personal account benefit of participants in 2050 by about 20 percent below our baseline. Variation in market returns also would affect personal account annuity benefits. For example, increasing real returns by one percentage point for both stocks and bonds and assuming that these rates will vary in the next 50 years in the same way that they have varied over the past 50

years could increase personal account benefits by almost 18 percent for participating individuals age 62 to 69 in 2050. On the other hand, assuming real returns of one percentage point less for stocks and bonds, along with less favorable market variation patterns, could reduce personal account benefits to less than half the level reached under the baseline Model 2 assumptions. The swing that we find in these results highlights the risks and rewards inherent in a system of personal accounts. They also highlight the importance of participation in personal accounts when the offset is this size.

Total Social Security benefits, including the basic benefit plus the personal account benefit, would likewise vary based on the personal account assumptions. Regardless of which assumptions we use, total Social Security benefits would fall below those promised under current law. Examining the results by particular subgroups provides additional insights into the potential impacts of Model 2. The model's enhanced widow benefit and inheritance of spouses' personal account balances improve the outcomes for widows, and the minimum benefit helps those in the lowest lifetime earnings quintile.

Changes in Social Security benefits would necessarily affect poverty rates among older adults in 2050. In particular, near poverty rates (family income below 150 percent of the federal poverty line) for some vulnerable groups, including divorced or never married individuals, blacks, and individuals without a high school diploma, would be higher if Social Security benefits are reduced to reflect projected revenues and even under the more optimistic personal account scenarios. If the more pessimistic assumptions regarding Model 2 outcomes prove to be true, near poverty rates could be higher for these vulnerable groups than under a simple uniform downward adjustment in Social Security benefits to achieve long-term (75-year) solvency. At the same time, widows and widowers see improvement in near poverty rates (just as they see in total benefits) under Model 2, even with pessimistic assumptions.

Our analyses come with several caveats. First, we find that Model 2 does not meet the needs of young disabled beneficiaries, who may not have time to build a large personal account balance. As the President's Commission acknowledged, the establishment of any personal account system would need to address these problems related to disabled beneficiaries. Second, we did not consider children who are dependent beneficiaries of deceased, retired, or disabled workers. A system with personal accounts will need to consider the disposition of account balances in these cases. While children could be held harmless, this would increase system costs. Finally, we make a number of key assumptions (all personal account participants annuitize their balances at retirement; pre-retirement withdrawals, loans, and lump sums are prohibited; persons who divorce prior to retirement split account accruals over the course of marriage; spouses inherit the accounts of workers who die prior to retirement). Without these mandates, retirement well-being could be compromised for some beneficiaries.

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