AARP

TESTIMONY BEFORE THE

SENATE SPECIAL COMMITTEE ON AGING

ON

SOCIAL SECURITY: DO WE HAVE TO ACT NOW?

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Good morning and thank you for inviting AARP to appear before the Committee to address the important issue of insuring the retirement security of millions of Americans by strengthening Social Security.

Social Security is a crucial part of America's retirement security system and probably the most successful federal program in history. People look upon it as a promise –without an expiration date– that our nation has made to America's workers and to those who have completed their worklife, our retirees.

The program has been periodically re-tuned as the workforce and work skills have changed. Yet, its administrative expenses remain the lowest of any government program—less than 1%. While the program insures families against loss of their breadwinner throughout life, Social Security also has proven to help millions of older Americans maintain their standard of living in retirement.

Social Security is financially strong now and in no danger of "going broke" anytime soon. There is no 'crisis' that demands immediate and radical restructuring of the system. However, it is true that the program is in need of long-term measures to keep it in fiscal balance so that it will be able to pay full benefits to every generation of Americans. The changes do not have to be drastic. However, the longer we wait to adjust the system, the more difficult the adjustments—that is why it is advisable to act sooner rather than later.

<u>One of four pillars</u>. Social Security is only part of the overall retirement security structure. A secure retirement is supported by four pillars: 1. Social Security, 2. Pensions and savings, 3. Continued earnings, and 4. Adequate and affordable health insurance. In that context, the importance of Social Security today is evident as each of the other pillars faces mounting pressures.

Less than 50% of working Americans have a pension plan available at their workplace, so half of all private sector workers have no regular payroll deduction mechanism to save for their future. Traditional defined benefit pensions are disappearing. Many companies that do offer pensions are converting to defined contribution plans, making workers absorb more risk. Defined contribution plans are subject to early withdrawals, poor investment decisions, and the failure to annuitize the account balance upon retirement. So, even if a worker has contributed to a retirement savings plan, it is likely to provide for a much less adequate retirement income level than defined benefit pensions.

Personal savings are at an all-time low according to Federal Reserve figures, and personal debt at an all-time high. In contrast to previous generations, who owned their homes free and clear by the time of retirement, many boomers may retire with substantial mortgages. Many report that they are planning to work in retirement. However, the job market for older workers is difficult for most without recent training and current skills, and age discrimination is still prevalent in the hiring process.

Rising health care costs also put strain on the goal of economic security. As health care expenses go up at almost double digits annually, insurers are reducing offerings, raising prices and shifting costs. Employers are cutting back on employee health benefits and retiree health benefits alike.

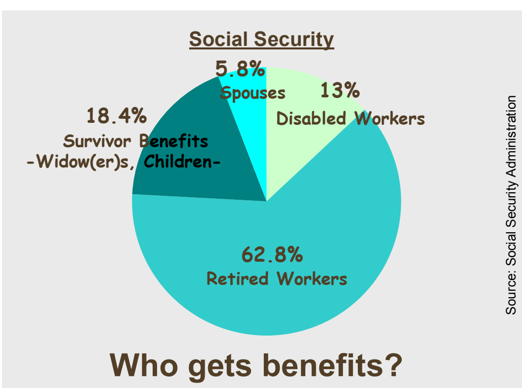
So retirees are paying larger and larger portions of their post-work income for health care. Even with Medicare eligibility the average older American is spending nearly a third of income for health care.

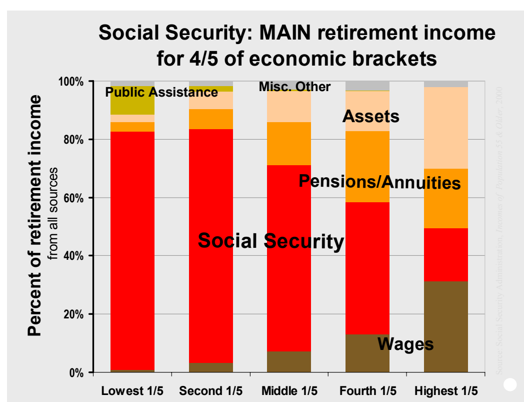
The average American today will need to work longer before retiring in order to: educate the kids, possibly assist elderly parents, save adequately for retirement without supplemental benefits from a company pension to count on, and meet ever-rising out-of-pocket health care costs. Since other pillars are under so much pressure, the need to strengthen Social Security is all the more important.

Who participates in Social Security?

About 96% of all workers contribute to Social Security. Workers pay 6.2% of their earned income into Social Security, matched equally by 6.2 % from their employer. The highest wage earners do not pay in to Social Security on the portion of their salary over the "taxable maximum." This figure is adjusted annually by formula and will be $90,000 a year in 2005.

Those who contribute for 40 quarters will earn retirement benefits. Today, approximately 47 million receive Social Security benefits. About 6% of beneficiaries are non-working married partners (mostly wives) whose payments are based on their spouses' earning record. Close to 19% of annual payments go to widowed spouses and children of deceased workers. Over 13% is paid to workers disabled during their work years. The remaining (less than 63%) goes to retired workers, beginning on a date of their choosing, but after age 62.





Source: Social Security Administration

For the majority of Americans – that is, for *two-thirds* of current and future retirees, Social Security is – or will be – the largest part of their income in retirement.

Adequacy of Benefits

The key measure of adequacy is the **"Income Replacement Rate."** Social Security is designed to favor the lower-wage worker, who might not have as much opportunity to save over a long worklife at the lower end of the wage scale. The Social Security benefit formula ensures lower-wage workers receive a higher wage replacement rate relative to their earnings so that their benefit might be more adequate.

RATE OF REPLACEMENT[1]

- 53.6% of low-wage workers' earnings replaced
- 39.9% of average-wage workers' earnings replaced
- 32.5% of high-wage workers' earnings replaced
- 24.8% of earnings replaced for those with consistent earnings at the taxable maximum

Any changes to Social Security's formulas must recognize the goal of adequacy. Changes must ensure that, both by initial payment level and by cost-of-living adjustments, the adequacy of Social Security as a partial replacement for pre-retirement income is maintained.

AVERAGE SOCIAL SECURITY BENEFIT - JANUARY 2005

Retired worker	$ 955
Retired couple, both workers	$1574
Widow(er) with 2 children	$1979
Widow(er) of retired worker	$ 920
Disabled Worker	$ 895

Fairness

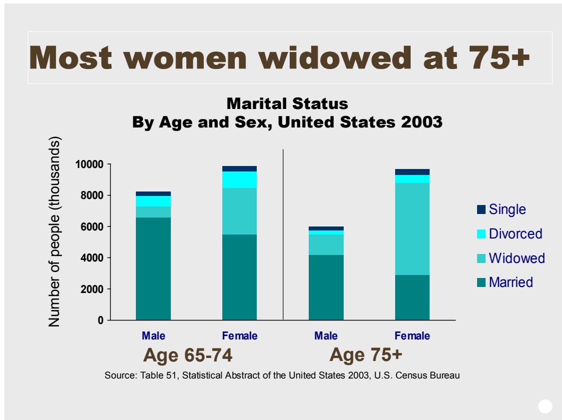
In an increasingly diverse nation where opportunities in the labor market have not been equally distributed in the past, another duty of those who would change the system is to promote fairness. African-American and Hispanic workers make up a disproportionate segment of the nation's low and moderate wage earners. At present, the Social Security benefit formula ensures some fairness in that all lower-wage workers receive a higher percentage replacement of salary in retirement relative to their lifetime earnings.

Life-expectancy *at birth* is still significantly lower for males of these groups. The lower life-expectancy has sometimes been used to show lower-wage earners potentially contribute more than they receive in benefits. However, life expectancy *at 65* differs by only about a year, and the gap is closing. A further balancing factor, in terms of distribution of funds, is that a higher percentage of low-wage workers draw disability benefits and a higher percentage of their families draw survivor benefits.

Women's equity issues. Women, too, are concentrated in low-wage work on average. Their median salary is $531 a week compared to $685 a week for men. In other words, women are paid about 78% of what men are paid, a figure which unfortunately tends to stand over a lifetime.

[1] Source: Social Security Administration website: accessed Dec 10: www.ssa.gov/OACT/TR02/lr6E11-4

For *one of every four* unmarried women over 75, the only source of income is their Social Security check. Since women tend to live longer, a Cost of Living Adjustment (COLA) calculated on the Consumer Price Index annually is crucial to keep these women from falling into poverty as they age. Women (and men) who have been married to other workers get the higher of either benefits accruing (as spouses) from their partner's work record or their own work earnings, but not both.



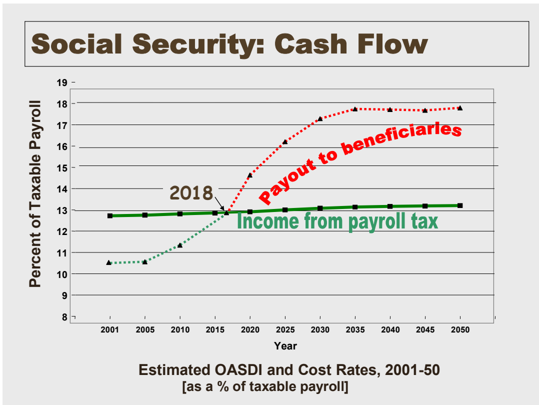
Poor & Near Poor, 2001 (within 150% of Poverty)

Age	Men	Women
60-64	16%	20%
65-74	17%	24%
75+	20%	33%

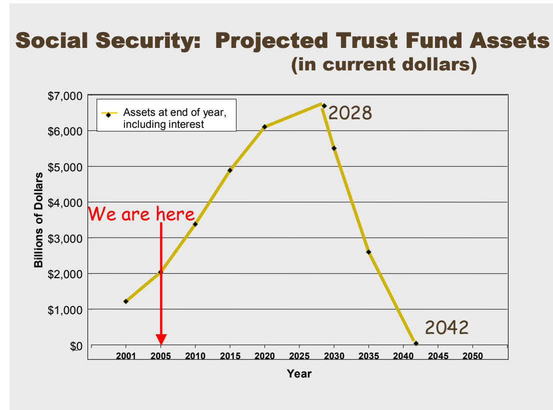
Solvency

Solvency is a major focus of the current reform discussion. According to the Social Security trustees, the system is out of long range balance by about 1.89% of payroll. Projections by the Congressional Budget Office show a smaller long-term deficit of only 1.00% of payroll over 75 years.

Because the Social Security system pays retirees, widows, orphans, and the disabled and their families each year out of the funds collected from current workers' payroll checks and some of the income taxes paid on benefits, it is sometimes referred to as a pay-as-you-go system. Demographic changes including slower workforce growth and longer lives affect the projected annual Social Security balance sheet. Recognizing well in advance the population bulge created when births were delayed by World War II (the phenomenon known as the baby boom), excess collections were legislated in the early '80s to create a surplus in the Social Security trust fund designed to meet the nation's obligations to boomers' retirement. For years, Social Security's income has exceeded its pay out, and the trust fund has grown.



Estimated OASDI and Cost Rates, 2001-50
[as a % of taxable payroll]



Today's trust fund reserve is $1.7 trillion, and another $155 billion will be added in 2005. This surplus is invested in special U.S. Treasury bonds that currently generate almost $90 billion in interest at an average rate of 6% for the trust fund. These bonds are backed by the full faith and credit of the United States. This means that the nation is fully obligated to honor them when they are redeemed.

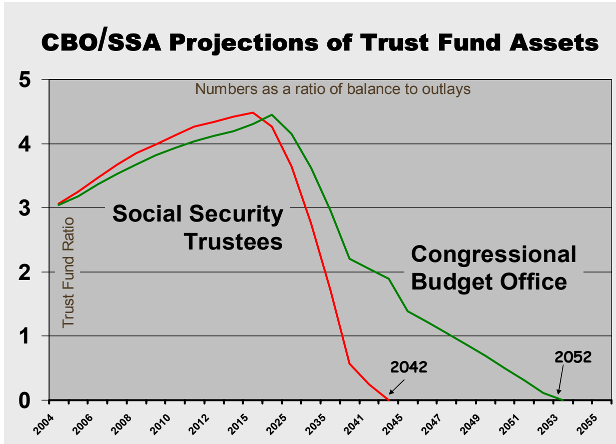
Annual payments *into* the trust fund —payroll contributions and dedicated taxes— are projected to *exceed* annual benefit payments until 2018. By then, the rising number of boomer retirees will have caused benefit payouts to rise. At that point, some of the interest that accrues each year will have to be combined with payroll and income taxes to pay retirees. In other words, the Treasury will have to make interest payments to the Social Security trust fund in cash rather than bonds.

2018 is a significant date for Social Security. It is important not because the program is in financial trouble at that point, but because the rest of the budget may be in trouble due to unsustainable fiscal policies. After more than 30 years of borrowing *from* Social Security, the U.S. Treasury will be called upon to transfer cash resources back to the trust fund. Right now the rest of government is borrowing more than $150 billion a year from Social Security, which Congress is using for various purposes at home and abroad.

So, 2018 is a problem not for Social Security but for Congress. Fiscal policy therefore is the cause for concern, not the ability of Social Security to continue to pay full benefits.

The situation changes again in 2028. Then, the annual payout will begin to exceed annual income plus interest earnings, and the bonds that the trust fund holds will need to start being redeemed. The Social Security actuaries conservatively project that the trust fund balance will be depleted by 2042. However, even after that date, Social Security will not be "bankrupt." *Annual collections from payroll taxes would be sufficient to pay over 70 % of promised benefits*.

The Congressional Budget Office (CBO), charged with projecting the costs of legislation for the U.S. Congress, has created an alternative model. Their model estimates that 2052, not 2042, as the possible trust fund depletion date, and only a 1% of payroll gap between income and benefits over the coming 75 years, assuming no changes.



This is significant because the CBO is using a very sophisticated new econometric model. Various economic and demographic assumptions plugged into the model result in a *broad range* of projected outlays and a narrower –but still significant– *range* of program income. This serves to point out that there is not just one "solution" to Social Security's "problem". The CBO entry into the debate is also significant because the current long-term imbalance looks only half as big through the CBO lens. The short-term cash flow is estimated to be the same. If the CBO projections are correct, more modest changes would be sufficient to guarantee current obligations and continuous trust fund solvency.

SOCIAL SECURITY SOLVENCY OPTIONS

We should work together to shore up the program, as soon as possible, for the long term so it will be there for all generations. But it is not necessary to dismantle Social Security in order to save it. A radical overhaul is not needed. If we make reasonable changes now, the program will be able to pay full benefits to the boomer generation and those that follow.

Here are two examples that, together, would get us more than half the way toward solvency:

First, we can restore the total wages taxed by Social Security to 90 percent of nationwide earnings, a historic level. Currently, only about 85 percent are subject to Social Security payroll taxes. The maximum wage subject to Social Security payments in 2005 is $90,000. Gradually raising that cap to $140,000 (perhaps phased in over 10 years) would lower the projected shortfall by some 43 percent.

Second, we can diversify Social Security's trust fund investments to increase the likelihood of higher returns. Today, the trust fund can only be invested in Treasury bonds. These are safe investments, but they have a modest rate of return. Currently trust fund bonds average about a 6% return. Investing some of these funds in a broad stock index fund -- as most state and other pension systems do -- could yield higher returns and lower the expected shortfall by some 15 percent.

Taken together, these two steps would lower Social Security's shortfall by 58 percent – and that is just for starters. There are a number of other possibilities that have been put forward. For example, extending Social Security coverage to make it universal, with appropriate transition relief reduces the shortfall by about 9%. AARP could support all three of these steps.

There are other changes that have been suggested for consideration to make Social Security solvent for future generations. Some of the more straightforward options that have been proposed at one time or another include:

- Gradually raise the retirement age to 70 by 2083 (reduces shortfall by 38 percent).
- Increase the number of work years calculated in the benefit formulas from 35 (the current base) to 38 (lowers the projected shortfall by 16 percent).
- Index the starting benefit level for longer lifespans or "average longevity" (lowers the projected shortfall by 25 percent).
- Reduce benefits for new retirees by 5 percent (lowers the projected shortfall by 26 percent).
- Raise the Social Security tax by ½ percentage point (from 6.2 to 6.45 percent each for employers and employees (reduces the shortfall by some 24 percent).
- Use a revised Consumer Price Index being developed by the Bureau of Labor Statistics that includes product substitution data ("superlative" index) for determining cost of living adjustments (COLA). (reduces the projected shortfall by 14 percent).

People are surprised when they learn that incremental steps like these can have such a significant impact on Social Security solvency. In discussions with our members around the country, and in a recent survey, we found that most people support making incremental changes in the program, and sooner rather than later. When these and other options are put before our members and the public, they are willing and able to make the choices to achieve balanced solvency packages. AARP will continue to get the views of our members and the public in general on these and other options and they should not be interpreted as endorsed by AARP.

*AA*RP is opposed to private accounts that divert money from Social Security payroll taxes. Private accounts are expensive. Money would have to be borrowed to fulfill promises to current beneficiaries and those close to retire while simultaneously creating millions of new accounts. Additional borrowing to fund an extended transition period would equal as much as $2 trillion over 10 years. Increasing our national deficit is not prudent fiscal policy at a time when deficit figures are already at record numbers.

Most younger workers today would have to pay twice to finance this new plan. First, current benefits must continue to be paid, even though there would be less revenue due to the diversion of payroll taxes into private accounts. So, borrowing must take place to meet these obligations, requiring additional interest payments and potentially higher interest rates. Second, the added debt must be paid off.

We understand that proponents of private accounts carved out of Social Security contend they would not affect current beneficiaries. But they have yet to tell us where the money would come from to protect them. Even more importantly, our members care about all generations, including, of course, their children and grandchildren. They want their legacy to be a better America for future generations, and they believe they have an obligation to ensure that Social Security remains strong. AARP and its members have good reason to be concerned about radical changes in Social Security.

Another policy to which AARP is strongly opposed is "price indexing." Overall Social Security benefits would gradually become smaller over time by price indexing initial benefit levels. Social Security today calculates initial benefit levels by indexing wage histories to overall growth in wage levels; retirees benefit from rising productivity during their worklife. Price-indexing would freeze the real value of earnings. This would result in about a 1% decrease in initial benefit level *per year* compounded for every year the policy is in effect. For example, *if price indexing had been in effect since 1955, today's benefits would be 42 percent lower. In other words, retirees, survivors and the disabled would have to live as if it were 50 years ago.*

Changing the benefit formula to price-indexing would by itself eliminate the projected trust fund deficit, but at the price of drastically lower income replacement rates for future generations.

Price Indexing Beneficiary Impact: Income Replacement Rates

Year of Birth	Current Law	Plan #2 Combined
1940	42.9%	42.8%
1950	43.0	39.9
1960	41.0	34.8
1970	40.5	30.9
1980	39.8	27.4
1990	39.5	24.6
2000	39.6	21.7

Beneficiary Impact: In dollars

Year of birth	Current Law	Plan #2 combined
1940	$14,900	$14,900
1950	$15,200	$14,100
1960	$15,500	$13,100
1970	$17,700	$13,600
1980	$20,500	$14,300
1990	$23,300	$14,500
2000	$26,400	$14,600

Source: Congressional Budget Office - July 2004

One example of the effect on Social Security benefits of a plan that combines price indexing with private accounts is the Congressional Budget Office's analysis of one of the plans designed by the President's Commission to Strengthen Social Security several years ago. As the accompanying table shows, *this plan would lead to reduced benefits, even after the returns from the private accounts are taken into account*. That is because the benefit amount provided by Social Security would *decrease at retirement* by the amount that was put into the account over the years plus an interest charge. This policy is referred to as a "clawback" to help fund solvency.

Criteria to Judge Options

This is not a comprehensive list but gives an idea of the range of the measures that might be adopted. Key questions in evaluating any comprehensive plan include: Are future benefits adequate? Are costs and benefits fairly spread? Who bears what risk? Are benefits still "progressive"? What is effect on public support, confidence, and understanding? Can people adjust easily to the change? How will the plan affect rest of the U.S. budget?

Our nation needs a full national discussion of *all* the ideas on the table. Now that Social Security has moved to the top of the political agenda, we must all work together to keep it adequate, equitable, and financially strong.

AARP

Policy Highlights

*AA*RP Supports

✓ Increasing wages subject to Social Security tax
✓ Diversifying investment of a portion of trust fund assets to increase return
✓ Adding newly-hired state/local workers
✓ Individual retirement accounts added to Soc Sec

*AA*RP Opposes

X Creating private accounts that divert payroll contributions away from Social Security
X "Price-indexing" benefits
X Reducing cost of living adjustments
X Increasing retirement age
X Means testing

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