Statement before the Special Committee on Aging
United States Senate

Social Security: Keeping the Promise for the 21st Century

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Chairman Kohl, Ranking Member Martinez, and members of the Committee. Social Security is the largest spending program of the federal government, the largest tax paid by most workers and the largest source of income for most retirees. It also faces a significant long-term funding challenge. For these reasons, I am glad you chose to hold this hearing and am thankful for the opportunity to testify here today.

In my testimony I wish to highlight three points.

- First, Social Security's long-term shortfalls worsened significantly in the latest Trustees Report, and is expected to continue to worsen if reform is delayed.
- Second, population aging, not rising per capita health care costs, is the principal driver of overall entitlement costs and the largest threat to the budget; and
- Third, Social Security policy should encourage longer work lives and simplify the program's complex benefit formula.

I will address these points in turn.

The 2009 Social Security Trustees Report

As you are probably aware, the Social Security Trustees Report, released in May, showed a worsening of the program's finances. There were three principal causes:

- The recession reduced payroll tax receipts and lowered interest rates (accounting for around 50 percent of the decline in the actuarial balance);
- Higher-than-expected improvements in life expectancies, which increases the number of beneficiaries (35 percent); and
- The simple passage of time, which adds an additional year of deficits to the 75-year period over which solvency is measured. (16 percent).

Worsening of the deficit due to increased life spans will remain even if the economy rebounds faster than the Trustees project.

Increases in the shortfall due to the passage of time, moreover, will continue for as long as Social Security reform is delayed. If we wait four years to enact reform, for instance, we can expect the problem needing to be resolved to be around 10 percent larger than today's.

Most focus is on changes in the date of initial cash deficits, which shifted from 2017 to 2016, and the date of trust fund exhaustion, which moved from 2041 to 2037. These dates are volatile and not too much emphasis should be placed on these changes.

More ominous, however, is that the program's total long-term deficit rose from 1.7 percent to 2.0 percent of payroll. This is an increase of almost one-fifth in the program's total shortfalls.

It is tempting to downplay the size of the Social Security shortfall. But as noted as the outset, Social Security is the largest single spending program of the federal budget and its costs are projected to grow by one third over the next two decades. Social Security's problems are "small" relative only to those of Medicare and Medicaid, but reforms to Social Security are better understood and easier to implement. As President Obama recently said, “Social Security, we can solve.”[1] By contrast, we don’t truly yet know how to fix Medicare and Medicaid.

Social Security, Population Aging, and Health Care Inflation

Which brings me to my second topic, which is to place Social Security and population aging in the context of overall increases in entitlement spending. There are two ways in which entitlement costs can increase: first, population aging, which increases the number of beneficiaries, and second, per capita benefit increases, which raises costs even if the beneficiary population does not rise.

It has become accepted that per capita health care inflation is the largest driver of entitlement costs -- in OMB director Peter Orszag’s terms, “the real deficit threat.”[2] Since rising health prices are common to both government programs and private sector health provision, the administration argues that only by exerting greater federal control over private sector health care can Medicare and Medicaid spending be curbed. “Health care reform is entitlement reform,” as the President has said.[3]

Costs associated with population aging, by contrast, are largely concentrated in government programs, since Social Security and Medicare dominate income and health care provision for seniors. Social Security costs are entirely driven by aging, while Medicare and Medicaid costs so include aging and per capital price growth.

Most importantly, both Congressional Budget Office and Office of Management and Budget projections clearly show that population aging, *not* rising per capita health costs, will be the largest driver of budget deficits and accumulated debt over the next several decades.

Figure 1

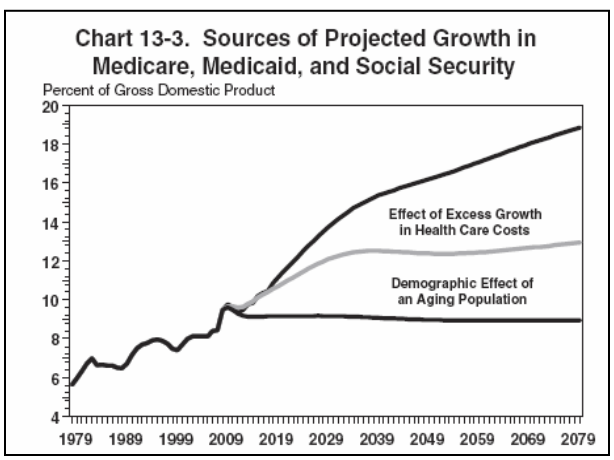

Figure 1 is reprinted from the administration’s Fiscal Year 2010 budget.[4] It shows the relative contributions of population aging and health care cost growth to the increase in overall entitlement costs. It is not until around 2050 that health care inflation becomes the largest driver of annual entitlement costs.

Figure 2 shows the accumulated debt that would be associated with financing these entitlement cost increases by borrowing. Even over 75 years, total entitlement costs attributable to population aging exceed those from per capita health care cost growth.

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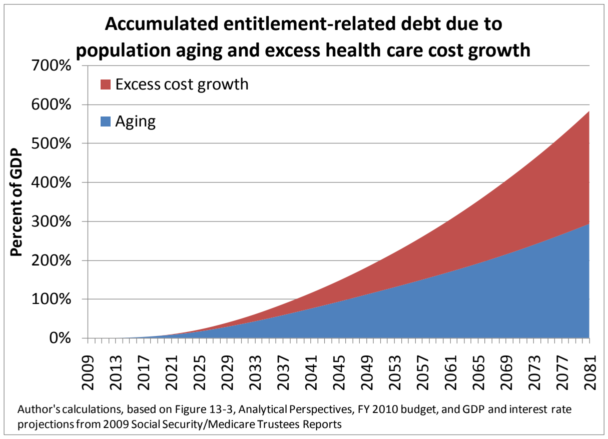
[1] “Obama Pledges Entitlement Reform.” *Washington Post*. January 19, 2009.

[2] Peter R. Orszag. “Health Costs Are the Real Deficit Threat.” *The Wall Street Journal*, May 15, 2009.

[3] Remarks by the President on the Economy, Georgetown University, Washington, DC, April 14, 2009. Available at http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-the-Economy-at-Georgetown-University/

[4] *Budget of the United States Government for Fiscal Year 2010*, Analytical Perspectives, p. 191

Figure 2



Unfortunately, we don't have 75 years to wait to fix these problems. Bond rating agencies warn that U.S. Treasury debt could be downgraded as early as 2017.[5] This fiscal crisis, if it comes, will be driven predominantly by aging, not health care inflation.

In short, even if the administration's efforts to rein in health care cost growth were wholly successful, we could nevertheless face a budget crisis driven by the costs of a graying population.

Policies to at least soften the effects of population aging deserve the consideration of Congress. These can be policies specific to programs like Social Security, such as increasing the retirement age, or they can macro policies such as raising skilled immigration or increasing the labor force participation of working age Americans. In particular, despite recent upticks, male labor force participation remains well below 1950 levels. Returning to those rates would produce significant increases in GDP, improvements in Social Security and Medicare financing, and – most of all – benefits to the individuals involved.

Policy Options

I now turn to my third area, which is policy. There are many areas of Social Security reform deserving attention, and I touch on some of them in my written testimony. I will here focus on two that may be less familiar to the Committee. First, the need to improve Social Security's incentives to delay retirement; and second, the costs imposed on retirees by the complexity of the Social Security benefit formula.

Longer Work Lives*:* Despite longer life expectancies and less physically taxing work conditions, workers are retiring earlier. Today the average worker retires at age 62 or 63, compared to 68 in the 1950s. To the degree that Social Security's funding shortfalls are exacerbated by rising life spans, it makes sense for individuals to respond by working longer. But Social Security's benefit formula does not encourage longer work lives.

While the Social Security benefit formula is roughly neutral with regard to the age of benefit claiming, it is not at all neutral with regard to additional years of work and payroll tax contributions. The Social Security benefit program only counts the highest thirty-five years of a retirees' career. For most workers, additional work late in life adds little to this calculation. In addition, individuals who receive spousal benefits rarely increase their benefits by additional work.

[5] For instance, see Kraemer, Moritz. "In The Long Run, We Are All Debt: Aging Societies And Sovereign Ratings." Standard & Poor's, June 28, 2005. Available at http://www2.standardandpoors.com/portal/site/sp/en/eu/page.article/2,1,1,2,1112292523641.html

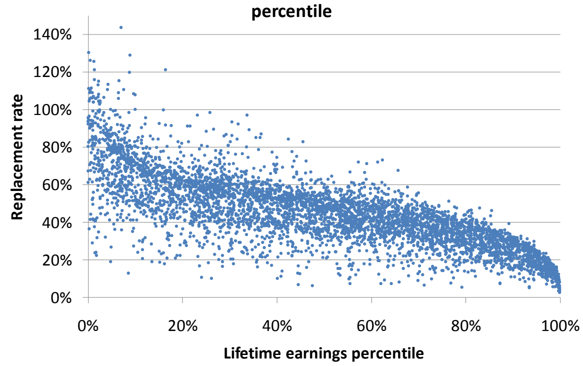
I and my –coauthors found that the typical near-retiree who works an additional year receives only around nine cents in additional lifetime benefits for each dollar of additional taxes they paid. This amounts to a marginal rate of return of negative 50 percent.[6]

To encourage delayed retirement, policymakers should consider lowering the Social Security payroll tax for older workers. A lower payroll tax would encourage these individuals to remain in the workforce and would make them more attractive to employers.

Benefit Simplification: While most discussion of Social Security reform understandably focuses on solvency issues, it is very important that this program be kept current with the needs of the population it serves. The Social Security benefit formula is remarkably complex, basing benefits on average wages, the number of years worked, whether the person is married or, if divorced, on the length of the marriage, on the relative earnings levels of husbands and wives, and other factors.

This has two significant negative effects: first, many working age individuals have little knowledge of what their future retirement benefits will be, making it more difficult to plan their other savings. Using the Health and Retirement Study, I found that almost one in four individuals on the verge of retirement cannot even guess as to their Social Security benefit level.[7] Of those who could make a prediction, one-third of near-retirees overestimated their benefits by at least 10 percent, while one quarter overestimated them by more than 28 percent. One in ten retirees received a benefit less than half as much as they expected. This "predictability risk" is every bit as damaging as having your 401(k) account decline on the verge of retirement.

Figure 3: Household replacement rates by lifetime earnings percentile

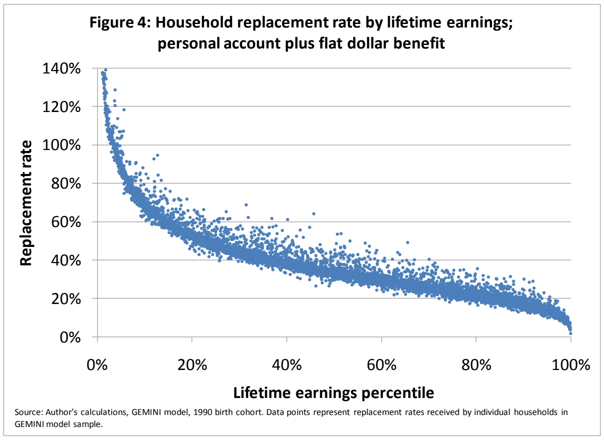


Source: Author's calculations, GEMINI model, 1940 birth cohort. Data points represent replacement rates received by individual households in GEMINI model sample.

A second effect of the benefit formula's complexity is that retiree households with the same lifetime earnings can end up with very different benefit levels. Social Security generally replaces a greater share of pre-retirement income for low-earners than for high-earners. But while the program is progressive on average, at any given earnings level benefits can differ significantly, particularly for low earners. As Figure 3 shows, many low earning households receive low replacement rates and many high earning households receive high replacement rates.[8]

[6] See Reznik, Gayle L. , David A. Weaver, and Andrew G. Biggs. "Social Security and Marginal Returns to Work Near Retirement." Social Security Administration, Issue Brief No. 2009-02, April 2009; Biggs, Andrew G. "Does It Pay to Work? The Case for Cutting the Social Security Tax for Workers near Retirement." *AEI Retirement Policy Outlook* No. 3, April 2009.
[7] Biggs, Andrew G. "Answer Quickly: How Much Do You Think You'll Get from Social Security? The predictability risk of Social Security retirement benefits." *AEI Retirement Policy Outlook* No. 4, June 2009. Forthcoming.
[8] Figures 3 and 4 are reprinted from Biggs, Andrew G. "Will Your Social Insurance Pay Off?" *AEI Retirement Policy Outlook* No. 1, January 2009.

For example, the average household at the 20th percentile of the earnings distribution receives benefits equal to 59 percent of their pre-retirement earnings. But this is only on average: 10 percent of those households receive replacement rates below 37 percent while another 10 percent receive replacement rates above 74 percent. Put another way, despite identical earnings over their lifetimes, some households receive benefits literally twice as high as others. This is like having a home insurance policy that may or may not pay off if your house burns down. It is not enough that Social Security be progressive on average; it must be *consistently* progressive.



New Zealand's pensions system might have lessons for the U.S. in this regard. New Zealand combines a flat dollar benefit paid to all retirees with auto-enrollment in personal accounts saving up to 8 percent of earnings. The U.K. has also made moves in this direction. Figure 4 simulates a stylized plan combining a flat defined benefit with a personal account. This stylized plan pays the same average benefits as Social Security and has the same overall progressivity. The difference is that this model reform targets its benefits far more precisely: low earners *consistently* receive higher replacement rates than high earners, enhancing the social insurance value of the program. In addition, this stylized plan would be far easier to understand than the current benefit formula. While any reform must be tailored to the needs and values of the United States, I believe these approaches deserve greater study and consideration.

In conclusion, rising entitlement costs, especially those caused by population aging, pose significant challenges to the country's financial future. While there are many problems in the Medicare and Medicaid systems that should be addressed, changes to Social Security provide a sure means to reducing the long-term fiscal gap. Congress should seriously consider reforms that encourage longer working lives and simplifies the program for the average American.

Thank you for your consideration. I will be glad to take any questions.

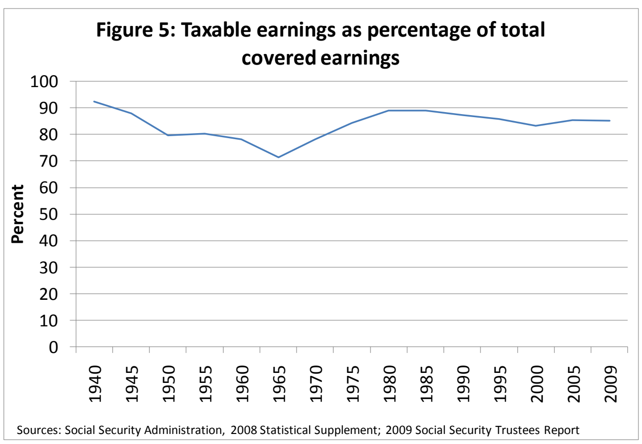
Addendum

Taxes

A not unreasonable argument can be made for achieving solvency by increasing taxes rather than reducing benefits: Social Security will provide the only defined benefit pension income for most future retirees, and as life spans increase it is not rational to pay more to support the increased lifetime benefits the system must provide.

However, unlike Medicare or Medicaid benefits, it is relatively easy to substitute increased personal saving for reduced traditional benefits. As tax increases are damaging economically, they should be limited to cases where individual action is least effective. For that reason, I generally oppose increasing Social Security taxes.

It is often argued that Social Security solvency should be addressed by increasing the maximum taxable wage, which is currently $106,800 and rises with average wage growth each year. Any reform plan that is enacted is likely to be a series of compromises, and so I would not be surprised if the wage cap were increased as part of any reform legislation. Nevertheless, we should be wary of doing so, for three reasons.



First, as Figure 5 shows, the current wage cap is not particularly low relative to historical norms. For 2009, the Social Security Trustees project that 85.2 percent of total wages will be subject to payroll taxes, a figure that is slightly above the average level since the program's inception. While many advocate increasing the cap to cover 90 percent of total wages, there were only two relatively short periods in Social Security's history in which taxes were this high.

Second, raising the taxable maximum constitutes a significant tax increase at the margin for affected individuals. While only around 6 percent of individuals have earnings above the cap in any given year, these are not the same individuals each year. Around 22 percent of workers have earnings above the cap at some point during their working lives, and increasing the cap would amount to an increase of almost 12 percentage points in their marginal tax rates. A total marginal tax rate exceeding 50 percent is easy to imagine, presenting significant disincentives to work and significant incentives to avoid taxes where possible, such as through increased use of so-called Chapter S corporations.

Finally, President Roosevelt established Social Security with a tax cap so the program would more closely resemble a private sector pension rather than a "welfare" plan that might cause a stigma to those who collect benefits and resentment from those who pay taxes. Social Security has remained popular in part because it is progressive, but not *too* progressive. Congress should bear this in mind as it considers reform options.[9]

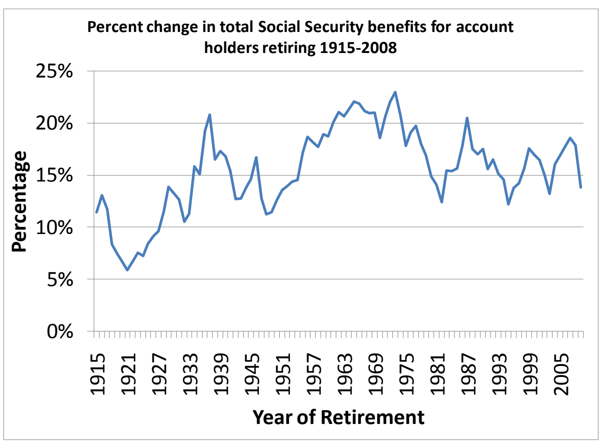
If taxes are to be increased, a case can be made that simply increasing the 12.4 percent payroll tax rate is the option that is fairest, most economically efficient, and most in keeping with Social Security's history. The payroll tax is portrayed as regressive, but this is true only when viewed in isolation from the benefits the tax "purchases." In fact, the "net Social Security tax" – that is, Social Security taxes minus the benefits they generate – is progressive and, for many low earning households, highly negative.[10] The net tax rate determines economic incentives and the overall progressivity of the program. Whether individuals would prefer to pay additional taxes to the Social Security program, versus saving more on their own, is a question policymakers should bear in mind.

Market Risk and Individual Investment

As members of the Committee know, the introduction of personal retirement accounts inside of the Social Security program was a central part of President Bush's reform proposal in 2005. For a variety of reasons, no doubt including the public's mixed views regarding the introduction of market volatility to Social Security benefits, that proposal was not accepted.

The recent market downturn provides an opportunity to "stress test" market investment.[11] To do so, I simulated a reform plan similar to that proposed by President Bush: individuals could invest 4 percentage points of the Social Security payroll tax in a personal account, which would hold a "life cycle fund" that automatically shifted from stocks to bonds as the worker aged. In return for diverting a portion of their taxes, workers would give up traditional benefits equal to their account contributions compounded at the interest rate earned by the Social Security trust funds. Had such a plan been in place, how would workers retiring in late 2008 have fared? Using historical stocks and bond data, I attempted to answer this question.

Figure 5



A worker who held a personal account his entire life and retired in October of 2008 would have increased his total Social Security benefits by around 15 percent, despite truly terrible stock market returns in the years approaching retirement.[12] This highlights the fact that long-term returns are

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[9] See Biggs, Andrew G. "Obama vs. FDR." *The American Magazine*, February 2, 2009. Available at http://american.com/archive/2009/obama-vs-fdr

[10] This issue is discussed at greater length and net payroll taxes are calculated at Biggs, Andrew G. "Is the Social Security tax regressive once you account for benefits?" *Notes on Social Security Reform,* December 29, 2008. Available at http://andrewgbiggs.blogspot.com/2008/12/is-social-security-tax-regressive-once.html

[11] The following discussion draws on Biggs, Andrew G. "Social Insecurity?" *AEI Retirement Policy Outlook* No. 1, November 2008.

important and that shifting from stocks to bonds over time, as a life cycle fund does, can reduce volatility as retirement nears. I went further, simulating 95 cohorts of retirees using stock and bond data from 1871 through 2008. As Figure 5 shows, all 95 cohorts would have increased their total Social Security benefits by holding an account. The average increase was 15 percent, with the smallest being 6 percent and the largest 23 percent.

I am under no illusion that accounts funded out of the payroll tax will be on the policy menu again anytime soon. However, as policymakers consider reform options, they may wish to think about so-called "add-on" personal accounts built on top of Social Security as an alternative to explicit tax increases. The simulations I performed regarding carve-out accounts imply that we should not overstate the risks from market investment as we consider whether to establish universal retirement saving accounts. Market downturns in any given year can be significant, but retirement saving is about the long-term and so a long-term focus is more appropriate.

[12] Workers who held a personal account for only part of their lives would have experienced smaller gains and, in the case of workers who established accounts at older ages, small losses. Maximum losses would have equaled 0.7 percent of total benefits.